

***United States Court of Appeals
for the
District of Columbia Circuit***



**TRANSCRIPT OF
RECORD**

321

IN THE
UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

National Association of
Securities Dealers, Inc.

Petitioner

v.

Securities and Exchange Commission:

No. 20,164

Respondent,

First National City Bank,

Intervenor,

PETITION FOR REHEARING EN BANC

Petitioner above named respectfully petitions for a rehearing en banc.

The Court, with one Judge concurring and one Judge dissenting, dismissed for lack of standing a petition for review filed by the National Association of Securities Dealers, Inc. ("NASD"). Review was sought of an order issued by the Securities and Exchange Commission ("the Commission")

United States Court of Appeals
for the District of Columbia Circuit

FILED DEC 6 1967

Nathan J. Paulson
CLERK

under the Investment Company Act of 1940. ^{1/} The NASD's standing was not challenged by the Commission, but by the intervenor, First National City Bank ("the Bank") which filed a motion to dismiss.

Rehearing en banc is requested because basic questions are raised as to the scope and application of underlying principles relating to a competitor's standing under "party aggrieved" statutes. The breadth and importance of these matters is evident from the dissenting opinion which indicates, for example, that new requirements are being imposed and that the approach adopted as to economic injury is wholly unrealistic.

BACKGROUND

The Commission's order granted certain exemptions to the Commingled Account, an open-end investment company

^{1/} Section 43(a) of that Act provides for review in this Court by "[a]ny person or party aggrieved by an order issued by the Commission under this title . . . " 54 Stat. 844, U.S.C.A., Title 15, §80a-42(a).

or mutual fund which the Bank proposed to sponsor. ^{2/} There is to be no charge or "load" on the sale of participations in the fund. The Bank is to manage this fund for a fee and distribute its securities. The Bank in its application for exemption stated that without exemption it would "be effectively precluded from" going forward (JA 10). ^{3/} With this grant of permission by the Commission, the enterprise was launched.

On the merits our position here, as below, is that the Commission contravened the statutory policy against bank dominated investment companies and exceeded its statutory

^{2/} Not all the exemptions were challenged.

^{3/} The reason for this is explained at pp. 19-20 of our brief on the merits.

The Bank did not file its motion to dismiss until after our brief on the merits had been submitted.

authority. ^{4/}

The membership of the NASD, which is a creature of the securities laws, is made up of 3,700 brokers and dealers, with 965 members in New York City. Approximately 90% of its members sell shares of open-end investment companies either as underwriters or as retailers. Sales of investment company shares are an important source of income. ^{5/}

An open-end investment company is essentially a managed portfolio of securities and its shares are distributed by others. As more fully discussed below, at stake in this "test" case is the market in which NASD members and the banks will vie as direct competitors for as much as two billion dollars of mutual fund shares over the next five to

^{4/} The Commission permitted precisely that which the Congress concluded was against the public interest and the protection of investors: an investment company that is part and parcel of a bank. As the dissenting Commissioner indicated, the Commission has usurped a Congressional function.

^{5/} These matters are more fully elaborated upon in the Petition for Review (p.3) and our answer to the Bank's motion to dismiss (p.6).

ten years. ^{6/}

6/ In Investment Company Institute v. Camp, ___ F. Supp. ___, Civil No. 1083-66 (D.D.C., September 27, 1967), which declared invalid the regulations of the Comptroller of the Currency authorizing the type of investment company here involved, the court rejected the contention of the Comptroller that the plaintiff, an organization of investment companies and their principal underwriters and investment advisers, lacked standing, observing:

"The exact amount of damages which will be incurred by the plaintiffs is rather difficult to assess in precise figures, but the Comptroller has predicted that over the next five to ten years, commercial banks might capture as much as two billion dollars of mutual fund business". (Slip Opinion, p.12)

In this connection in view of the statements here (Slip Opinion pp. 10 and 14) it is noteworthy that the Comptroller in arguing lack of standing distinguished amongst the three categories of members of the plaintiff association and concluded: "It would thus appear that the real plaintiffs in this action are the underwriters of mutual funds. The gravamen of their complaint is that the existence of the Commingled Account might cut into their selling commissions from the sale of mutual fund shares." Memorandum in Support of Cross Motion for Summary Judgment, p.9 note 4. These underwriters are also members of the NASD.

See also Baker, Watts & Co. v. Saxon, 261 F. Supp.247 (D.D.C., 1966).

THE INTEREST REQUIRED

Contrary to the majority opinion, ^{7/} where as here there is a "statutory aid to standing", ^{8/} a person aggrieved is not limited to a "licensee" under the statute involved or to one who can "show that it has a legal or property right which is adversely affected by the order of the administrative agency" (Slip Opinion, pp. 10 and 11). This approach ignores settled precedent of this Court. It construes, we submit incorrectly, Fugazy Travel Bureau, Inc. v. C.A.B., 121 U.S. App. D.C. 355, 350 F.2d 733 (1965), which was decided on the merits, as sub silentio overruling

^{7/} As did the dissenting Judge we shall refer to the lead opinion as the majority opinion, although we are uncertain as to whether in fact it is. It is clear that the two majority Judges joined in the concurring opinion.

^{8/} United Milk Producers of N.J. v. Benson, 96 U.S. App. D.C. 227, 229, 225 F.2d 527, 529 (1955).

this precedent. ^{9/}

The following cases are illustrative of persons who had standing although they did not meet the above requirements: National Coal Association v. F.P.C., 89 U.S. App. D.C. 135, 191 F.2d 462 (1951), ^{10/} City of Pittsburgh v. F.P.C., 99 U.S. App. D.C. 113, 237 F.2d 741 (1956) ^{11/} and Philco Corporation v. F.C.C., 103 U.S. App. D.C. 278, 257 F.2d 656 (1958), ^{12/} International Union of E.R. & M. Wkrs. v. United States, 108 U.S. App. D.C. 97, 280 F.2d 645 (1960). See also Clarksburg Publishing Co. v. F.C.C. 96 U.S. App. D.C. 211, 225 F.2d 511 (1955) ^{13/} . Compare Office of Communication of United Church of Christ v. F.C.C., 123 U.S. App. D.C. 328, 359 F.2d 994 (1966). ^{14/}

^{9/} Fugazy is analyzed in detail in our memorandum in opposition to the motion to dismiss (pp.22-28).

^{10/} The facts are set forth in our memorandum in opposition to the motion to dismiss, p.20.

^{11/} Ibid., pp. 20-21.

^{12/} Ibid., pp. 7, 38.

^{13/} Ibid., p.34.

^{14/} Ibid., pp. 5, 33.

The guiding principles were set forth in the comprehensive opinion in Associated Industries v. Ickes, 134 F.2d 694 (1943), vacated as moot, 320 U.S. 707 (1943), ^{15/} which the Supreme Court cited with approval in American Power and Light Co. v. S.E.C., 325 U.S. 385 (1945). ^{16/} In National Coal Association, supra, this Court stated:

"We agree with the rationale which that case draws from the Supreme Court's decisions in the Sanders [F.C.C. v. Sanders, 309 U.S. 470 (1940) ^{17/}] and Scripps-Howard [Scripps-Howard Radio v. F.C.C., 316 U.S. 4 (1942) ^{18/}] cases: '* * * one threatened with loss through increased competition resulting from a Commission's order is "aggrieved" and entitled as such to a review notwithstanding that the very statute pursuant to which he obtains review is designed to keep competition alive and confers upon him no property right which gives him any kind of immunity from competition.' The "person aggrieved" review provisions [is] a constitutionally valid statute authorizing a class of "persons aggrieved" to bring suit in a Court of Appeals to prevent alleged unlawful official action in order to vindicate the public interest, although no personal substantive interest of such persons had been or would be invaded.'" 191 F.2d at 464-465.

The purpose of Sanders, which rejected the proposition

^{15/} Ibid., pp. 16-20.

^{16/} Ibid., pp. 28-29.

^{17/} Ibid., pp. 14-16.

^{18/} Ibid., p. 16.

that "absence of right implies absence of remedy", ^{19/} and its progeny is to foster judicial oversight of agency action. The thrust of Sanders, as here pertinent, is that the judicial review provision will be made meaningful if a competitor, "likely to be financially injured" ^{20/} is a "person aggrieved" because as a practical matter he "would be the only person having a sufficient interest" ^{21/} to seek review and vindicate the public interest. He assumes the role of a private attorney general. Viewed in this light, where there is a "person aggrieved" provision, there is no reason to limit Sanders to any particular type of agency function or form of agency action as the majority opinion suggests. In any event, as indicated above the permission granted by the Commission was in fact a license without which the investment company could not have been launched.

^{19/} 309 U.S. at 477.

^{20/} Ibid.

^{21/} This is precisely the situation here. See our memorandum in opposition to motion to dismiss, p. 3.

REMOTENESS OF INJURY

The conclusion in the concurring opinion (Slip Opinion, p. 14) that the NASD asserts only a "tenuous likelihood of injury" is refuted, for example, by the Bank's own statement below:

" . . . it would be of great importance to members of the NASD if the nation's leading banks were to succeed in establishing a widely attractive investment medium which . . . would reduce the market for the investment companies' shares which they distribute. And for this feeling they need have no apology." 22/

As we pointed out in our memorandum in opposition to the motion to dismiss (at p. 8) the Bank's executive vice president has testified that the Bank, which was serving one out of every five families in the New York metropolitan area in 1963 when it had 108 branches (it now has 164) is "after the fellow who is already our customer, but who goes elsewhere with money he wishes to put in equities because we can't take care of it." And the Bank is not limited to its customers.

But the consequences go beyond this case, which by itself introduces a major competitor in the New York City area. This

22/ Transcript of oral argument, p. 64.

is a test case. As we pointed out in our memorandum (p.9) the Commission, speaking of its decision, has stated: "A pattern has thus been set which other banks may follow if they see fit", and this interest of other banks has been amply demonstrated repeatedly in their position during Congressional hearings. Just this past month a spokesman for the American Bankers Association testified: "The entry of the banks into the investment company industry . . . will greatly increase the available choices to purchasers of investment company shares." ^{23/} As is to be expected mass entry by other banks into the mutual fund business is awaiting the outcome of this litigation and that referred to in note 6, supra. ^{24/}

^{23/}Hearings on Amendment No. 438 to S.1659, 90th Cong., 1st Sess. before the Senate Committee on Banking and Currency (November 16, 1967), p. 1223. The proposals would render moot this litigation and that referred to in note 6, supra.

^{24/}The New York Times, on April 20, 1967, (Section 3, p.1) reported: "Other New York banks are known to be considering similar mutual funds, but they are likely to wait until a legal snarl resulting from the First National City's operation is untangled." The article pointed out that one of the banks awaiting the outcome of the litigation was The Chemical Bank New York Trust Company, a spokesman for which said that it "was geared up and ready to go" and "predicted that eventually 'every major bank in the business' would be planning such a mutual fund."

The dollar magnitude of the business is indicated by the following estimate of the Comptroller of the Currency, who recognized the competitive implications:

"Over the next five to ten years, therefore, we would expect that the assets of managing agency accounts invested in collective investment funds [the type of investment company here involved] would not exceed \$2 billion." 25/

Nor should the significance of the competitive impact here be misjudged by the fact that the minimum investment here is \$10,000. In 1966, an investment company industry spokesman testified:

" . . . the bulk of the new money being raised today for mutual funds is raised by sales in excess of \$10,000." 26/
He characterized such sales as the cream of the business.

25/ Hearings before the Subcommittee on Commerce and Finance of the Interstate and Foreign Commerce, House of Representatives, 88th Cong. 2d. Sess. on H.R.8499, H.R.9410, pp. 26, 51. The prediction was made in connection with a bill that provided for minimum participation of \$10,000.

26/ Hearings before a Subcommittee of the Senate Committee on Banking and Currency, 89th Cong., 2d Sess. on S.2704, p.96.

The concurring opinion likens the position of the NASD to the unsuccessful standing claimant in United States Cane Sugar Refiners Ass'n v. McNutt, 138 F.2d 116 (C.A. 2, 1943). It is submitted that there is no parallel. In that case producers of cane sugar were held to have no standing to contest a regulation under the Federal Food, Drug and Cosmetic Act which permitted, without the disclosure on the label of canned fruits, the use of dextrose and corn syrup as sweeteners. The producers' interest was held too remote because:

"What the petitioners are really claiming is that the regulations will do away with the remote, speculative sales resistance of the public to the marketing of canned fruits sweetened in some part with dextrose or corn syrup which might be present if the labels on the cans disclosed, by naming them, that the permitted amounts of one or the other or both of the optional sweeteners had been added to the required sugar."
138 F.2d at 120-121.

For the reasons already given, the competition here and likelihood of financial injury is neither "remote" nor "speculative". Furthermore, the asserted interest in the cited case did not, as is true here, relate to competition with the product which was subject to regulation, a factor to

which this Court has pointed in distinguishing the case. ^{27/}
Moreover, in United States Cane Sugar Refiners' Assn., the
court, before reaching its conclusion as to remoteness, pointed
out that there "is no claim that the permitted sweeteners,
other than sugar, are not wholesome . . . " 138 F.2d at 120.
Here, as pointed out above, it is our position that what is
being permitted by the Commission contravenes basic statutory

^{27/} In National Coal Association, supra, this Court pointed
out: " . . . nor were they competitors in the production
and sale of it [i.e. canned fruit] . . . " 191 F.2d at 465.

Moreover, standing has been recognized by this Court even
where there is no such direct competition. See Philco, supra.

policy. ^{28/}

^{28/} In view of references in the majority opinion to the NASD having tardly filed its request for participation below and that it did not introduce evidence below as to economic injury (Slip Opinion, pp. 5, 7 and 10), the situation should be clarified. The Commission issued a notice of filing of the Bank's application which advised that any interested person could request a hearing by September 20, 1965 (JA 36). Pursuant to a telephone conversation with the Secretary of the Commission, the NASD, by a letter of September 21, 1965 (Record, Doc. No.5), requested an extension until October 1, 1965, when the NASD filed its request to be heard and served the Bank (Doc. No. 11). Thereafter in response to an inquiry from the Commission's staff, the NASD advised, as it had in its request, that the Bank's application did not set forth either a factual or legal basis for the relief requested; that if the Commission ordered an evidentiary hearing the NASD sought participation therein; and that otherwise it would submit briefs and make oral argument. By order of October 20, 1965 (JA 42), the Commission established a procedure for briefs and oral argument, without an evidentiary hearing, and granted the NASD participation. The Commission in that order incorrectly stated that the Bank had challenged our standing, but by-passed the issue, as it did in its later opinion on the merits (JA 54). The Bank in a letter of October 6, 1965 to the Commission's staff (Doc. No.9) had challenged the standing of the Investment Company Institute. In a footnote (at p.3) in the Bank's brief on the merits filed on November 22, 1965, at which time the NASD's brief was also filed and which (at p.3) called attention to the Commission's error in its order, the Bank stated that it "does not concede that any of the objectants had the requisite standing to request a hearing or to participate in the proceeding, and expressly reserves its rights with respect to this issue".

CONCLUSION

For the foregoing reasons, this petition should be granted.

Respectfully submitted,

Lloyd J. Derrickson
General Counsel
National Association of
Securities Dealers, Inc.
888 17th Street, N.W.
Washington, D.C. 20006

Joseph B. Levin
Brown Lund & Levin
1625 Eye Street, N.W.
Washington, D.C. 20006

December 1967

CERTIFICATE

I hereby certify that the foregoing petition for rehearing
en banc is presented in good faith and not for delay.

Joseph B. Levin

IN THE
UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

National Association of
Securities Dealers, Inc.
Petitioner,,

v.

Securities and Exchange Commission
Respondent,

First National City Bank,
Intervenor,

No. 20,164

CERTIFICATE OF SERVICE

I hereby certify that copies of the attached Petition for Rehearing En Banc have today been served upon Respondent and Intervenor by mailing copies thereof, postage prepaid, to:

Philip A. Loomis, Jr., Esq.
David Ferber, Esq.
John A. Dudley, Esq.,
Leonard S. Machtinger, Esq.
Securities and Exchange Commission
500 North Capitol Street, N. W.
Washington, D. C. 20549

Samuel E. Gates, Esq.
320 Park Avenue
New York, New York 10022

Stephen Ailes, Esq.
Henry C. Ikenberry, Jr., Esq.
1250 Conn. Ave., N. W.
Washington, D. C. 20036

Joseph B. Levin
Counsel for Petitioner

December 6, 1967

IN THE
UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

United States Court of Appeals
for the District of Columbia Circuit

FILED JUL 23 1969

Nathan J. Paulson
CLERK

National Association of
Securities Dealers, Inc.,

Petitioner

v.

Securities and Exchange Commission

Respondent,

First National City Bank,

Intervenor,

No. 20,164

PETITION FOR REHEARING
and
SUGGESTION FOR REHEARING IN BANC

The National Association of Securities Dealers, Inc.,
("NASD") respectfully petitions for a rehearing on the merits
and suggests that the rehearing be in banc.

The Court in a per curiam decision (1) affirmed orders
under the Investment Company Act of 1940 ("the Act") entered
by the Securities and Exchange Commission ("the Commission"),
which the NASD had challenged on a petition for review, and

(2) reversed the District Court in certain appeals involving the banking laws in which the NASD was not involved, but which the Court consolidated with the subject proceeding for decision. (Slip Opinion, hereafter referred to as "Op." p. 3. note 1.) The reasons for the Court's action are set forth in a concurring opinion of Judge (now Chief Justice) Burger, in which Judge Miller concurred, and in a concurring opinion of Chief Judge Bazelon. (Op. 4)

I

Judge Burger emphasized "the need for judicial examination of the important questions raised." (Op. 47) Indeed, he reluctantly concurred that the appellees had standing to sue

"in order to make a majority holding for review of the merits of a subject of such importance. I do so in order to reach consideration of the merits for such aid as some examination at our level may be useful to further judicial review." (Op. 36)

Yet the merits are summarily treated in the last two paragraphs of his 13 page opinion, without even a reference to the issues and arguments involved.^{1/} Stating that the Court's

^{1/}As we read the note on Op. 36, coupled also with other references in the opinions (pp. 4 and 48), Judge Burger and Judge Miller did not join in the treatment and discussion contained in Judge Bazelon's opinion of the merits under the Investment Company Act.

IN THE
UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

United States Court of Appeals
for the District of Columbia Circuit

FILED JUL 23 1969

Nathan J. Paulson
CLERK

National Association of
Securities Dealers, Inc.,

Petitioner

v.

Securities and Exchange Commission

Respondent,

First National City Bank,

Intervenor,

No. 20,164

PETITION FOR REHEARING
and
SUGGESTION FOR REHEARING IN BANC

The National Association of Securities Dealers, Inc.,
("NASD") respectfully petitions for a rehearing on the merits
and suggests that the rehearing be in banc.

The Court in a per curiam decision (1) affirmed orders
under the Investment Company Act of 1940 ("the Act") entered
by the Securities and Exchange Commission ("the Commission"),
which the NASD had challenged on a petition for review, and

(2) reversed the District Court in certain appeals involving the banking laws in which the NASD was not involved, but which the Court consolidated with the subject proceeding for decision. (Slip Opinion, hereafter referred to as "Op." p. 3. note 1.) The reasons for the Court's action are set forth in a concurring opinion of Judge (now Chief Justice) Burger, in which Judge Miller concurred, and in a concurring opinion of Chief Judge Bazelon. (Op. 4)

I

Judge Burger emphasized "the need for judicial examination of the important questions raised." (Op. 47) Indeed, he reluctantly concurred that the appellees had standing to sue

"in order to make a majority holding for review of the merits of a subject of such importance. I do so in order to reach consideration of the merits for such aid as some examination at our level may be useful to further judicial review." (Op. 36)

Yet the merits are summarily treated in the last two paragraphs of his 13 page opinion, without even a reference to the issues and arguments involved.^{1/} Stating that the Court's

^{1/}As we read the note on Op. 36, coupled also with other references in the opinions (pp. 4 and 48), Judge Burger and Judge Miller did not join in the treatment and discussion contained in Judge Bazelon's opinion of the merits under the Investment Company Act.

"review function is narrow and limited" (Op. 47), the Opinion's consideration of the merits consists essentially of the following:

"The regulatory bodies charged by Congress with these large responsibilities have construed the grant of power and with their accumulated expert experience have decided these issues. Their decisions are entitled to substantial deference and on this record I see no basis for disturbing their conclusions." (Op. 48)

Speaking of "limited judicial review," the Supreme Court, however, has cautioned:

"But where, as here, the review is not of a question of fact, but of a judgment as to the proper balance to be struck between conflicting interests, '[t]he deference owed to an expert tribunal cannot be allowed to slip into a judicial inertia which results in the unauthorized assumption by an agency of major policy decisions properly made by Congress.'" NLRB v. Brown, 380 U.S. 278, 292 (1965)

At issue here is a novel and basic matter of policy- whether the Commission is authorized to abandon the explicit Congressional prohibition against a bank dominated investment company. As Commissioner (now Chairman) Budge pointed out in his dissenting opinion:

"If the specific prohibition of the Congress in this broad policy area is to be avoided, it should be done by the Congress and not

through the granting of ad hoc exemptions
by the Commission." JA 70

II

The opinion of Chief Judge Bazelon acknowledged the existence here, in varying degree, of potential conflicts of interest in the relationship between the First National City Bank and the Commingled Account, an investment company managed by the Bank (Op. 20-24). It is respectfully submitted that the opinion overlooks and misapprehends matters that go to the very heart of the issue before the Court.

Whether the Commingled Account is like the security affiliates of the banks in the twenties is irrelevant, as is the fact that the Account is subject to supervision by the Comptroller of the Currency. Yet these factors became focal points of the analysis. (Op. 19-20,24) The opinion, it is respectfully submitted, failed to consider and give heed to the purpose and function of Section 10 (c) from which the Commission granted an exemption.^{2/} Indeed, the opinion simply

^{2/}Section 6 (c) of the Act empowers the Commission to grant an exemption from a statutory provision "...if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

appears to disagree with the Congressional judgment embodied in Section 10 (c).

The Congressional concern was with conflicts of interest that arise from the interlock between an investment company, on the one hand, and a commercial bank or other business interests, on the other hand. The bank interlock had produced some of the worst examples of abuse revealed by the Commission's study of investment companies which led to the passage of the Act. To contend with the conflicts problem, the statute contains a panoply of investor safeguards. It prohibits self-dealing, imposes fiduciary obligations on investment company managements, and provides for Commission supervision, including periodic inspection of investment companies, and for various civil and criminal enforcement measures.

But even this arsenal was not enough to deal with the conflicts problem, so often subtle and elusive. Congress prescribed a further prophylaxis, a "double-barreled" protection as it was then described. Various restrictions were imposed in Section 10 on the composition of an investment company's board of directors. In Section 10 (c) the Congress specifically decreed that hereafter "no registered investment

company shall have a majority of its board of directors consisting of persons who are officers or directors of any one bank".^{3/} This it should be noted was viewed as a compromise and a minimum prophylaxis, for there were advocates, including commercial bankers themselves, of a complete prohibition against any bank interlock.^{4/}

And the Congress meant that the Section 10 (c) prophylaxis it had selected as a necessary weapon to contend with the conflicts problem should be all embracing, as it explicitly stated in Section 10 (c). Indeed, from the very manner in which Section 10 is structured it is clear that the Congress sought to reach investment companies which had no resemblance to the securities affiliates of the twenties, a critical point to which the opinion did not address itself.^{5/}

^{3/}By 1940 there remained only one or two bank dominated investment companies and they were left untouched under the grandfather clause of Section 10 (c) so that the section had only a prospective effect.

^{4/}See NASD Brief pp. 8-17; 26-27 and Reply Brief pp. 3, 8, for a discussion of the legislative history and statutory provisions.

^{5/}See NASD Reply Brief, pp. 5-6. To whatever extent, if any, it may have affected the opinion's analysis, the Commission study of investment companies that led to the passage of the Act was made, not prior to (Op. 19, note 14), but after the adoption of the Glass-Steagall Act.

The Congressional concern was with the conflicts of interest problem generated by the bank interlock and its impact on investment companies generally. The remedy Congress prescribed, therefore, has, as was intended, general application to all investment companies. Certainly there is nothing to suggest that the remedy was to be applied selectively with a consequent denial to certain investors of this important safeguard, particularly where, as here, there are acknowledged potential conflicts of interest.

Reliance in the opinion on the Comptroller's supervision as reason for abandoning Section 10 (c) misconceives the purpose and function of the section.

The Congress specifically charged the Commission with the supervision of investment companies. The Commission is empowered to conduct periodic inspections of investment companies comparable to those of the Comptroller,^{5/} a matter to which the opinion makes not even a reference, although it assigns to the Comptroller's supervision a preeminence and importance to override Section 10 (c). Congress obviously,

^{6/}See NASD Reply Brief p. 8.

and for good reason, did not consider supervision by a government agency, which is a policing and enforcement device, as a substitute for a prophylactic rule. Had Congress thought otherwise there would have been no need to enact Section 10 (c) because it had provided for Commission supervision. Congress found it necessary in dealing with as difficult a matter as the conflicts problem to impose both policing and prophylaxis. Moreover, policing, whether done by one agency or two agencies, does not nullify the need for prophylaxis, which seeks to achieve compliance by a different approach.

The opinion states (Op. 18):

"The real issue is whether exemptions allowing an extra director on the Bank side will undercut the Committee's [i.e. the Board of Directors'] watchdog role in areas of potential conflict of interest."

The short answer is that the Congress declared that it would so do when it drew the line in Section 10 (c). The watchdog the Congress insisted upon must be made up of a majority not in bank management. Only then in the statute's view is there an effective watchdog. Indeed, what is posed here as the "real issue" is not one for the Court, or for the Commission, to decide. Congress has already made the decision.

It is respectfully submitted that fundamentally the opinion seems to disagree with the Congressional judgment embodied in Section 10 (c). The characterization of the matter at hand as involving "the absence of an independent tie-breaker" (Op. 24) reflects a misapprehension as to what is at stake. There can be a vast difference generally in the non-bank directors' sense of independence, responsibility and initiative, and also in a bank's sense of accountability to and impact upon the board, if the bank's presence is felt by a minority rather than a majority representation on the board. Moreover, even if all that were at stake is "the absence of an independent tie-breaker," that by itself is critically important. This function is neither to be minimized nor disparaged. Who controls the board is a crucial factor in corporate life. In any event, the controlling consideration here is the fact that Congress drew the permissible line in Section 10 (c) and considered that line the point of consequence to achieve the intended prophylactic purpose. Whether the Court or the Commission agrees with this judgment as to where the line should be drawn, neither has any alternative but to enforce it, for this is the policy of the statute.

Considered in this statutory context, the opinion's conclusion (Op. 24) that the Commission made "a fair trade" with the Comptroller when it abandoned Section 10 (c) misses the point. The question is not whether the trade was fair, but whether the Commission was authorized to trade at all. For the reasons stated above, the Commission was not empowered to bargain away the very remedy the Congress had selected to deal with the conflicts of interest problem. Certainly where the problem exists, and admittedly it does here, only the Congress may withdraw this investor safeguard which it concluded would be the only effective watchdog where there is a bank interlock.

With respect to the potential conflicts of interest themselves, the opinion finds one aspect of the "bird-dog" problem particularly troublesome. "Allocation of brokerage for the Bank's benefit is a subtler form of self-dealing...and one less amenable to control through disclosure and supervision by the agencies." (Op. 23) The opinion then observed:

"Nonetheless, brokerage may be improperly distributed in the course of banks' already extensive securities purchases for the account of customers, and it is appropriate to point out that Congress apparently did not consider this threat to be of critical significance when it exempted common trust funds from the Act entirely." (Op. 23)

If banks may now^{be}/otherwise "improperly" distributing brokerage, is this any reason to enlarge the potential incidence of impropriety by sterilizing a statutory prophylaxis which seeks to prevent abuse? Furthermore, there is no warrant for the inference drawn from the statutory exception for common trust funds. There was no in depth study made of such funds, and the reason for the exemption, as explained by the Commission, is:

"It [Congress] rested this exemption on the special considerations that the funds were used for bona fide fiduciary purposes rather than as a medium for general public investment and had only a limited impact in the investment fund picture."

7/The Prudential Insurance Company of America, Investment Company Act Release No. 3620, p. 11 (January 22, 1963), affirmed 326 F. 2d 383 (c.a.3. 1964), which adopted the quoted language, 326 F. 2d at 358; cert. denied, 377 U.S. 953.

The Commission's report on Commingled or Common Trust Funds Administered by Banks and Trust Companies included in its study on Investment Trusts and Investment Companies, which led to the passage of the Act, states (at p. 1):

"The Commission, however, did not make the same type of study and investigation of the common trust funds as it did of investment trusts and investment companies. Detailed studies were not made either through questionnaires or field investigation of individual common trust funds to ascertain the economic functions performed by, or possible defects and abuses existing in, these organizations. This report, therefore, is of limited coverage, and merely indicates the nature, growth, magnitude, and the present status of the regulation, both federal and state, of common trust funds." (Empasis added.)

[continued on next page]

Another aspect of this "bird-dog" problem is having the investment company make an investment in order to get the banking business from the company whose securities the investment company bought.^{8/} This matter is disposed of by reference to the self-dealing prohibitions of the statute (Op. 22, note 17), but, as already pointed out, these prohibitions are not reason to deny the "double-barreled" protection of Section 10 (c).

The opinion speaks of "reduced potential conflicts of interest in bank sponsored funds." (Op. 24) But the Bank will have control of the day to day management of the Account (Op. 18), and in these circumstances, the conflicts problem rather than being reduced, emerges probably as sharply

7/[cont.]

The most recent data referred to in the Commission's report on common trust funds was for the year 1935 when there were 16 such funds with aggregate assets of only \$38,695,000 (Report, p.4). The Commission pointed out (Report, p.5): "The small number of commingled or common trust funds in existence may be attributable in part to the fact that the sponsorship of common trust funds by the banks in the Federal Reserve System has been sanctioned by the regulations of the Federal Board only since December 1937."

8/See NASD Brief, p. 28.

as it ever could.^{9/}

The opinion states "that the exemptions would permit the establishment of a desired new investment medium..."

(Op. 19). The desire, of course, is on the part of the commercial banks. However, the Congress concluded that a bank dominated investment company, certainly where, as here, there are potential conflicts of interest, is undesirable and not to be visited upon investors.

This case sets a pattern and similar bank-sponsored investment companies are sure to follow. (Op. 35)

^{9/}See NASD Reply Brief, pp. 2-3. It should be noted that there was no evidentiary hearing in which the relationships were explored. The only reason given by the Bank in its application to justify the requested exemption was that without it the Bank would be unable to engage in the investment company business.
JA 10

For the foregoing reasons, this petition and suggestion should be granted.

Respectfully submitted,

Joseph B. Levin
Brown Lund & Levin
1625 Eye Street, N.W.
Washington, D.C. 20006

Lloyd J. Derrickson
General Counsel
National Association of
Securities Dealers, Inc.,
888 17th Street, N.W.
Washington, D.C. 20006

July 1969

CERTIFICATE OF SERVICE

I hereby certify that, on this 23rd day of July, 1969,
I made service of the foregoing petition and suggestion by
mailing copies thereof, postage prepaid, as follows:

Alan S. Rosenthal, Esq.
Department of Justice
Washington, D.C. 20530

G. Duane Vieth, Esq.
1229 Nineteenth St., N.W.
Washington, D.C. 20036

David Ferber, Esq.
Solicitor
Securities and Exchange
Commission
Washington, D.C. 20549

Stephen Ailes, Esq.
Steptoe & Johnson
1250 Connecticut Avenue, N.W.
Washington, D.C. 20036

Joseph B. Levin

IN THE
UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

United States Court of Appeals
for the District of Columbia Circuit

FILED DEC 18 1967

National Association of
Securities Dealers, Inc.

Petitioner,

v.

Securities and Exchange Commission

Respondent,

First National City Bank,

Intervenor.

Nathan J. Paulson
CLERK

No. 20,164

ANSWER OF INTERVENOR, FIRST NATIONAL
CITY BANK, IN OPPOSITION TO PETITION
FOR A REHEARING EN BANC

Intervenor, First National City Bank (the "Bank"),
opposes Petitioner's (NASD) request for a rehearing en banc.

The decision of this Court handed down November 21,
1967, is correct. Furthermore, the decision presents no ques-
tion of general importance in the law of standing and is entirely
consistent with all decisions in this Circuit.

Judge Miller's majority opinion accurately records
the history of this proceeding, the facts surrounding the
creation of the Commingled Account by the Bank, and the various
rulings of the Comptroller of the Currency, the Securities and

Exchange Commission and the Federal Reserve Board which form the background of this proceeding. The petition for rehearing contests none of the factual conclusions contained in the majority opinion, nor indeed could it do so.

The decision of the Court can rest upon any of three elements peculiar to the instant case; and, in fact, it is premised on all three.

1. Petitioner is not a direct competitor of the Bank nor of its Commingled Account nor has it shown substantial injury. Through the Commingled Account, the Bank offers an investment service hitherto unavailable to those with large sums to invest. The competition for the opportunity to manage other people's money is not only keen but extensive. Investment management is offered to the public, in one form or another, by savings banks, savings and loan associations, insurance companies, mutual funds, and, for that matter, by government itself in the form of a continuous offering of debt obligations.

Petitioner and its security dealer members are "in competition" with the Commingled Account only in the same loose sense as countless other salesmen who are competing for the customer's money — real estate salesmen, insurance salesmen, automobile salesmen, boat salesmen, and travel agents. Similarly, other business concerns who earn revenue from mutual fund advertising may be said to have some stake in the growth of mutual funds free from competition by other investment media which do not advertise. No court has ever held that those so remotely affected have standing to seek review of an administrative order.

Petitioner here is not comparable to the rival radio station given standing in FCC v. Sanders, and to the coal companies and others in National Coal Association v. FPC, even if these cases were otherwise appropriate which they are not. To allow petitioner to obtain review of the SEC order would be comparable to giving standing to persons doing business with the radio station in Sanders, or to the railroads and labor unions in National Coal Association, even if the railroads and unions had been unable (which was not the case) to show substantial economic injury. The opinions of Judge Miller and Judge Burger emphasize this point. (Slip Opinion, pp. 7, 10, 14).

2. The SEC's order which petitioner seeks to challenge is not the basic charter allowing the Commingled Account to do business in competition with mutual funds but is only a determination that three members of its governing Committee could be affiliated with the Bank, instead of two (Slip Opinion, pp. 10-11). It is the SEC's order which is here in issue. That order did not authorize the Bank to establish the Commingled Account. It merely granted a limited exemption affecting the manner of doing business. It is one thing to allow a person to challenge administrative action opening the field to a competitor. It is quite another thing to allow everyone affected by business rivalry to challenge details of the manner in which a competitor is or is not organized. Something more than a general claim of a competitive relationship and an interest in the outcome are required to give standing.

It is not enough for petitioner to allege the possibility of injury. It must be shown that the injury directly flows from the administrative action being challenged. The distinction taken by Judge Miller is surely sound in principle. The decision of the Court deals only with the limited facts of this case and is not in conflict with any other decision of this Circuit.

3. Both Judge Miller and Judge Burger relied upon the fact that petitioner, although its standing was challenged, made no effort to show either the manner or the extent of the alleged economic injury (Slip Opinion, pp. 10, 14).

The obvious fact is that the interest of the NASD is an interest in sales commissions—an interest which is diametrically opposed to the purposes of the Investment Company Act in protecting investors. Moreover, the possibility of injury to this interest in sales commissions is speculative, remote and insubstantial. The gist of the NASD's claim is that another "no-load mutual fund" has entered the field. There will now be 51 instead of 50 such funds. The members of the NASD cannot profit from the operations of "no-load" funds, but their inability to exact a commission from the Bank's customers is not the kind of injury which should give petitioner standing to object to an administrative action pursuant to a statute designed to protect the investing public.

Nowhere in the record before this Court is there any evidence — only unsupported, conclusory allegations — with

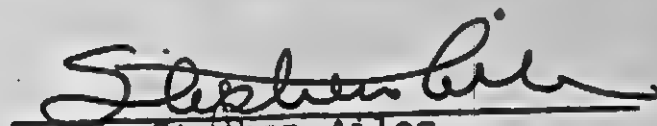
respect to this loose complaint of injury, nor to support any finding of injury, even to an unprotected interest. Moreover, petitioner specifically waived any claim to an evidentiary hearing. This fatal deficiency in the record is not cured by references in the petition for rehearing to speculation by government or bank officials as to the amounts of money which might be entrusted to the banks rather than to the funds whose shares are sold by petitioner's members.

In sum, the decision now in effect does not present the general questions that the petition for rehearing en banc seeks to raise. The petition focuses upon certain language in the opinions which it employs out of context, and then ignores the three critical elements of the case upon which the decision plainly rests. Clearly, the majority opinions do not limit the right to review to one who can "show that it has a legal or property right which is adversely affected by the order of the administrative agency". Nor does the decision retreat from the rulings of the Supreme Court and other decisions of this Circuit giving standing to those who suffer immediate and substantial economic injury as a direct consequence of an agency decision awarding a license and to those who fall within the so-called "consumer" class. Petitioner's difficulty is that it cannot bring itself within either of these broad categories.

Since the decision is consistent with prior rulings in the Circuit and no important question of standing is presented, rehearing en banc should be denied.


Samuel E. Gates

320 Park Avenue
New York, New York 10022


Stephen Ailes

1250 Connecticut Avenue
Washington, D. C. 20036

Attorneys for First National
City Bank

Debevoise, Plimpton, Lyons & Gates
Steptoe & Johnson

Of Counsel

Dated: December 18, 1967

Certificate of Service

I hereby certify that I have served the foregoing Answer of First National City Bank to Petition for Rehearing En Banc upon the following persons pursuant to Rule 31(g) of this Court by mailing on December 18, 1967 copies thereof, postage prepaid, addressed as follows:

Upon the National Association of Securities
Dealers, Inc.:

Lloyd J. Derrickson
General Counsel
National Association of Securities
Dealers, Inc.
888 17th Street, N. W.
Washington, D. C. 20006

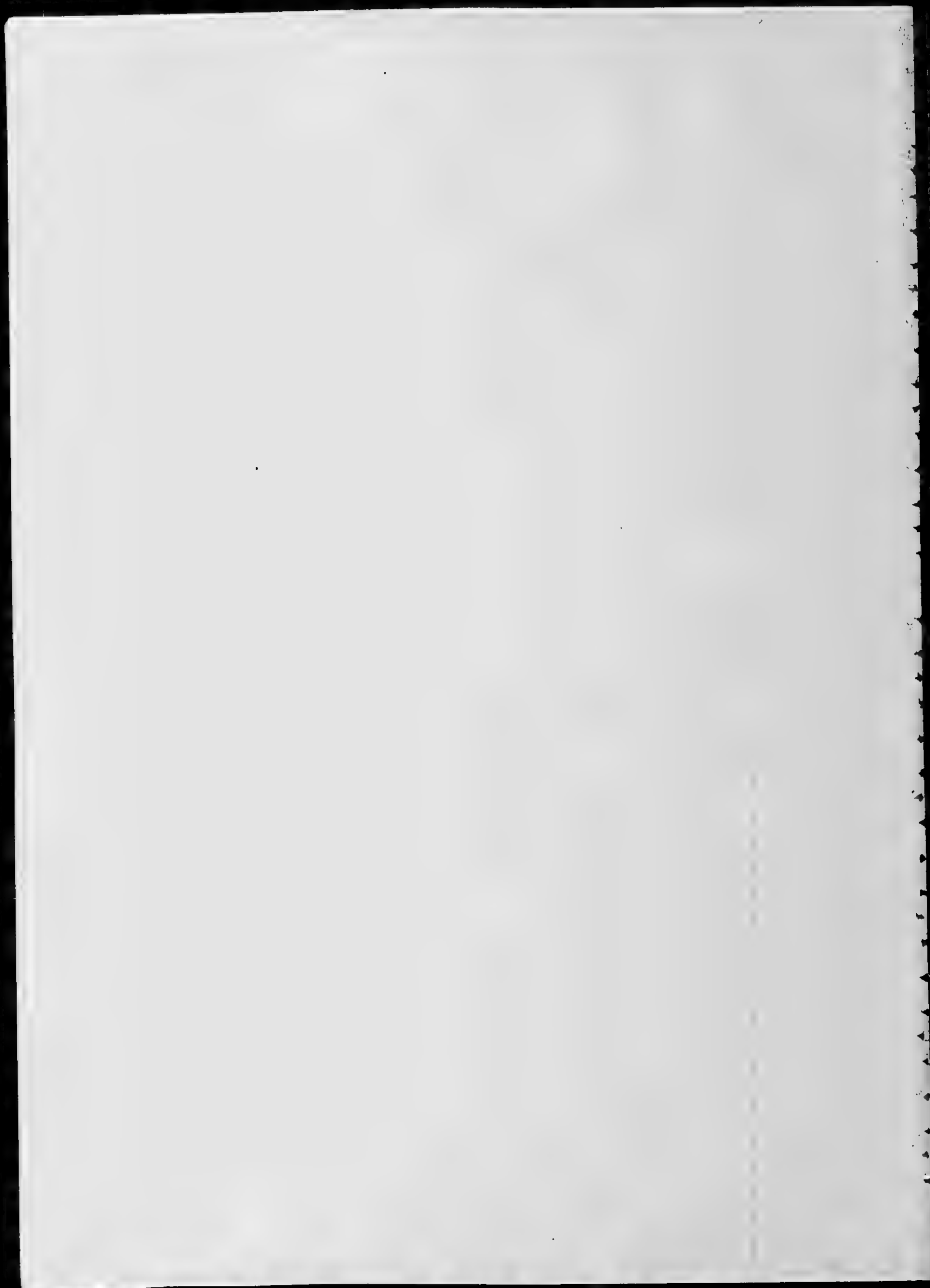
Joseph B. Levin
Brown Lund & Levin
1625 Eye Street, N. W.
Washington, D. C. 20006

Upon the Securities and Exchange Commission:

Philip A. Loomis, Jr., Esq.
David Ferber, Esq.
John A. Dudley, Esq.
Leonard S. Machtinger, Esq.
500 North Capitol Street, N. W.
Washington, D. C. 20549


Stephen Ailes

Dated: Washington, D. C.
December 18, 1967



JOINT APPENDIX

114/67
(3)

IN THE
United States Court of Appeals
for the District of Columbia Circuit
FOR THE DISTRICT OF COLUMBIA CIRCUIT
FILED AUG 12 1966

Nathan J. Paulson
No. 20,164 ~~CLERK~~

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent,*
FIRST NATIONAL CITY BANK, *Intervenor.*

On Petition To Review an Order of the
Securities and Exchange Commission



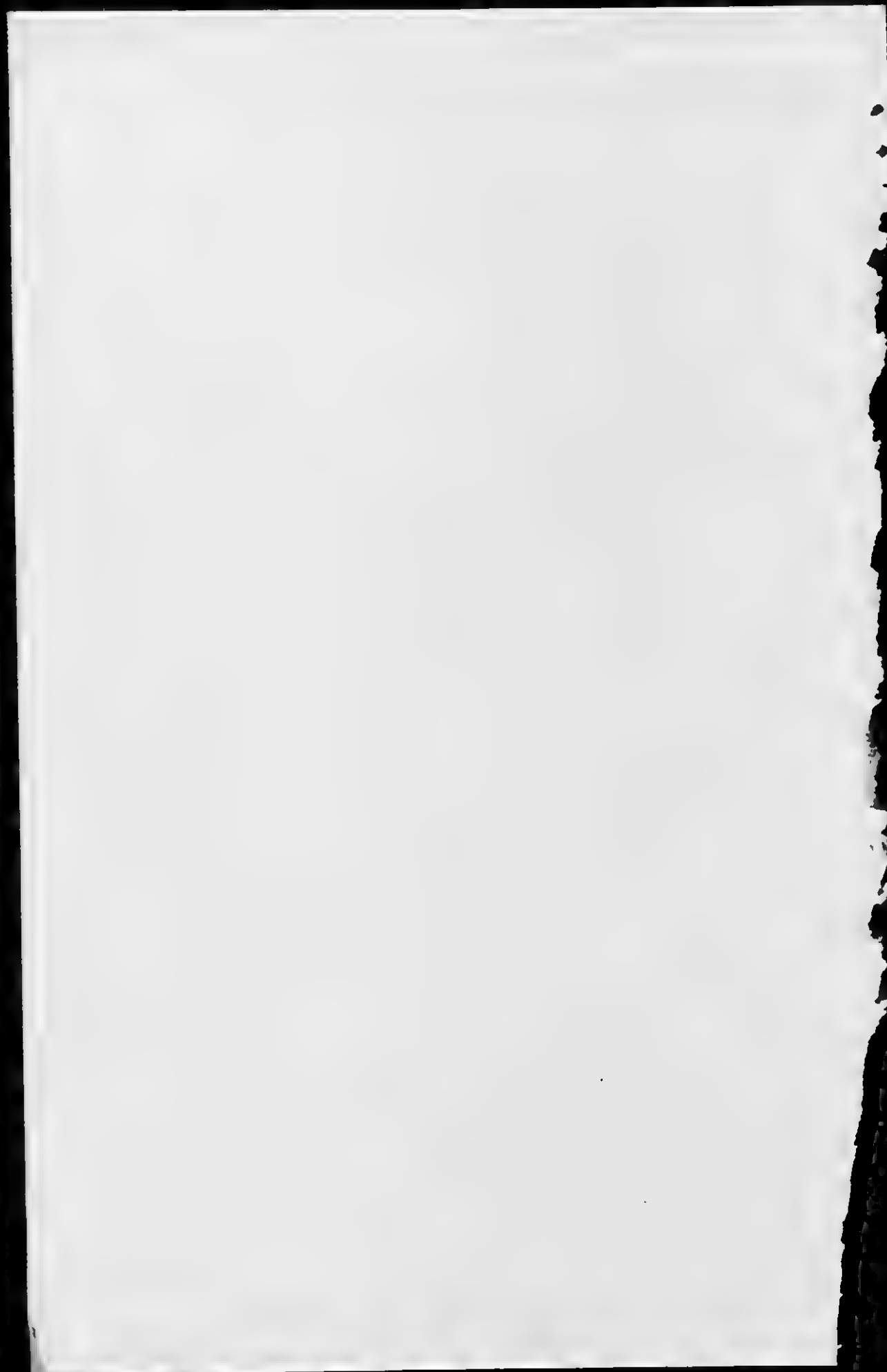


TABLE OF CONTENTS

	Page
Application of the First National City Bank, filed with the Commission August 24, 1965, pursuant to Section 6(c) for order of exemption from provisions of Sections 10(b)(3), 10(c), 10(d)(2), 15(a), 16(a), 17(f), 17(g) and 32(a)(2) of the Investment Company Act of 1940	2
Exhibit A: Prospectus (draft of August 19, 1965) Commingled Investment Account	15
Exhibit B: Management Agreement (draft of April 12, 1965) Commingled Investment Account	29
Notice of the Commission, dated September 2, 1965, of filing of application pursuant to Section 6(c) for an order of exemption from Sections 10(b)(3), 10(c), 10(d)(2), 15(a), 16(a), 17(f), 17(g) and 32(a)(2) of the Investment Company Act of 1940, in the matter of First National City Bank (Commingled Investment Account)	36
Order of the Commission, dated October 20, 1965, establishing the procedure for the filing of briefs and the presentation of oral argument respecting an application for an order of exemption from certain Sections of the Investment Company Act of 1940	42
Motion for amendment, filed December 8, 1965, on behalf of the National Association of Securities Dealers, Inc.	44
Order of the Commission, dated December 17, 1965, denying motion and granting extension to December 28, 1965, for the filing of reply briefs	45
Letter of the Comptroller of the Currency, dated May 10, 1965, approving Commingled Investment Account, included as Exhibit A of brief of First National City Bank in answer to motion for amendment of National Association of Securities Dealers, Inc.	47

	Page
Findings and Opinion and Order of the Commission, dated March 9, 1966	52
Correction of Findings, Opinion and Order of the Com- mission, dated March 14, 1966	73
Petition for rehearing filed March 14, 1966, on behalf of the National Association of Securities Dealers, Inc.	75
Order of the Commission, dated April 6, 1966, denying petition for rehearing	77
Prehearing Conference Stipulation—Court of Appeals	80
Prehearing Order—Court of Appeals	84

IN THE
United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 20,164

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent,*
FIRST NATIONAL CITY BANK, *Intervenor.*

On Petition To Review an Order of the
Securities and Exchange Commission

JOINT APPENDIX

BEFORE THE SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C.

In the Matter of

FIRST NATIONAL CITY BANK
399 Park Avenue
New York, New York 10022

Investment Company Act of 1940

Application pursuant to Section 6(c) for order of exemption
from provisions of Sections 10(b)(3), 10 (c), 10(d)(2), 15(a),
16(a), 17(f), 17(g), and 32(a)(2)

I. STATEMENT OF FACTS

In order to make its investment management services available to a larger number of customers, First National City Bank (the "Bank"), a national banking association, proposes to accept custody and investment discretion as to minimum accounts of \$10,000 pursuant to an agreement signed by the customer authorizing the Bank to invest such funds, together with the funds of other customers who have given the Bank the same authority, in a single Commingled Investment Account (the "Commingled Account") in which each such customer shares in proportion to the amount of his funds which are included.

The Commingled Account will be established in the State of New York pursuant to resolutions of the Board of Directors of the Bank and will be operated as a collective investment fund pursuant to applicable regulations of the Comptroller of the Currency. Prior to the issuance by the Securities and Exchange Commission (the "Commission") of any order pursuant to Section 6(c) of the Investment Company Act of 1940 (the "Act") with respect to any exemption requested in this Application, the Commingled Account will be registered under the Act as a diversified, open-end management investment company.

For convenience in defining the proportionate interest in the Commingled Account of each participating customer ("Participant"), the Commingled Account will be divided into units of participation of equal value. At meetings of Participants, each Participant will be entitled to one vote for each unit of participation held by such Participant. These and other matters relating to the operation of the Commingled Account are described in greater detail in the proposed Prospectus with respect to the Commingled Account (to be filed as part of its registration statement on Form S-5 under the Securities Act of 1933) attached hereto as Exhibit A.

At present, no customers of the Bank have been admitted to participation in the Commingled Account and the Commingled Account has no assets. Following the registration of the Commingled Account under the Act, it is intended to obtain the initial \$100,000 required by Section 14(a) of the Act through an initial private offering of units of participation at \$10 per unit to a small group of persons intending to acquire such units for investment. Following the effective date of the Commingled Account's registration statement on Form S-5 under the Securities Act of 1933, funds of customers of the Bank will be added to the Commingled Account as of specified valuation dates, their accounts being credited with units of participation at the net asset value of such units determined for such valuation dates. The Commingled Account will have no underwriter. The Bank will, as agent for each customer who has signed the required authorization, take the necessary steps to have the customer's funds admitted to the Commingled Account.

The operation of the Commingled Account will be subject to the supervision of a committee (the "Committee") of at least three persons. The members of the Committee will initially be appointed by the Bank. Thereafter, the members of the Committee will be elected by the Participants at annual meetings. It is expected that the first annual meeting of the Participants will be held not less than 60 nor more

than 90 days after the end of the Commingled Account's first fiscal year.

One of the purposes of this Application is to seek exemption from certain provisions of Section 10 of the Act, as more fully discussed below, so that all the members of the Committee, except one, may be affiliated persons of the Bank. If these exemptions are granted, it is intended that all of the members of the Committee who will initially be appointed by the Bank will be officers of the Bank, except for one or more members who will be individuals wholly independent of the Bank.

Prior to the commencement of operation of the Commingled Account, it is expected that the Committee will enter into a management agreement with the Bank, subject to the approval of the Participants at their first annual meeting. Pursuant to the agreement, the Bank will maintain a continuous investment program for the Commingled Account, will determine what securities are to be purchased or sold for the Commingled Account and will execute transactions for the Commingled Account accordingly. The Bank will furnish administrative and clerical services required for the operation of the Commingled Account, and will act as custodian of the securities and other assets of the Commingled Account. The Commingled Account itself will have no officers or employees. A copy of the proposed management agreement is attached hereto as Exhibit B.

It is expected that the Committee will select, within 30 days of the establishment of the Commingled Account and with the concurrence of members of the Committee who are not affiliated with the Bank, a firm of independent public accountants as the accountants for the Commingled Account's first fiscal year. It is expected that within 30 days before or after the beginning of the second fiscal year, the selection of the accountants will be renewed by the Committee for such second fiscal year. The selection of the accountants for the second fiscal year will be submitted for ratification or rejection at the first annual meeting of the Participants.

II. RELEVANT STATUTORY PROVISIONS

A. *Section 10(b)(3)*

Section 10(b)(3) of the Act provides that no registered investment company shall have as director, officer, or employee any investment banker, or any affiliated person of an investment banker, unless a majority of the board of directors of such registered company shall be persons who are not investment bankers or affiliated persons of any investment banker. The Bank may be deemed to be an "investment banker" as defined in Section 2(a)(20) of the Act since it from time to time participates in syndicates underwriting U. S. Government and municipal obligations.

B. *Section 10(c)*

Section 10(c) of the Act provides that no registered investment company shall have a majority of its board of directors consisting of persons who are officers or directors of any one bank.

C. *Section 10(d)(2)*

Section 10(d) of the Act provides that a registered investment company may have a board of directors all the members of which, except one, are affiliated persons of the investment adviser of such company, or are officers or employees of such company, if certain conditions are met. One of these conditions (Section 10(d)(2)) is that such investment adviser be registered under the Investment Advisers Act of 1940 and be engaged principally in the business of rendering investment supervisory services as therein defined.

D. *Section 15(a)*

Section 15(a) of the Act provides that it shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written

contract, which contract, among other things, has been approved by the vote of a majority of the outstanding voting securities of such registered company.

E. Section 16(a)

Section 16(a) of the Act provides that no person shall serve as a director of a registered investment company unless elected to that office by the holders of the outstanding voting securities of such company, at an annual or a special meeting duly called for that purpose.

F. Section 17(f)

Section 17(f) of the Act provides that a registered management company may place and maintain its securities and similar investments in the custody of a bank (as defined in Section 2(a)(5) of the Act) meeting certain requirements as to its capital, surplus and undivided profits, or in the custody of such registered company itself, but in such latter case only in accordance with such rules and regulations or orders as the Commission may prescribe. Rule 17f-2 issued thereunder provides, among other things, that investments maintained by a registered management company with a bank under an arrangement whereby the directors of such company are authorized or permitted to withdraw such investments upon their mere receipt are deemed to be in the custody of such company and may be so maintained only upon compliance with the provisions of Rule 17f-2.

G. Section 17(g)

Section 17(g) of the Act provides that the Commission is authorized to require by rules and regulations or orders for the protection of investors that any officer and employee of a registered management investment company who may singly, or jointly with others, have access to securities or funds of any registered company be bonded by a reputable fidelity insurance company in such reasonable minimum

amounts as the Commission may prescribe. The Commission has issued Rule 17g-1 prescribing the manner in which the amount of such bonds is to be determined and requiring certain filings and the giving of certain notices.

H. *Section 32(a)(2)*

Section 32(a) of the Act makes it unlawful for any registered management company to file with the Commission any financial statements signed or certified by an independent public accountant unless certain conditions have been met. One of these conditions (Section 32(a)(2)) is that the selection of such accountant by the board of directors shall have been submitted for ratification or rejection at the next succeeding annual meeting of stockholders if such meeting be held.

I. *Section 6(c)*

Section 6(c) of the Act provides that the Commission, by order upon application, may conditionally or unconditionally exempt any person or transaction from any provision of the Act or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

III. THE REQUESTED ORDER

A. *Affiliations of Members of Committee*

It is intended that the Commingled Account comply with the provisions of Section 10(d) of the Act so that all members of the Committee except one may be affiliated persons of the Bank, which will be the Commingled Account's investment adviser. It is impossible, however, to comply with paragraph (2) of Section 10(d) since the Bank is by definition not an "investment adviser" within the meaning of Section 202(a)(11) of the Investment Advisers Act of 1940

and therefore cannot register under such Act. Moreover, while the rendering of investment supervisory services as defined in Section 202(a)(13) of the Investment Advisers Act of 1940 is an important aspect of the Bank's business, it may be that the Bank is not "engaged principally" in rendering such services. Accordingly, an order of the Commission pursuant to Section 6(c) of the Act is respectfully requested exempting the Commingled Account from compliance with Section 10(d)(2) of the Act so long as the Bank shall be acting as investment adviser to the Commingled Account.

If all but one of the members of the Committee are to be persons who are affiliated with the Bank, an exemption from Section 10(c) of the Act will also be necessary and an exemption from Section 10(b)(3) of the Act may be necessary to the extent that the Bank is deemed to be an "investment banker" as defined in Section 2(a)(20) of the Act. Accordingly, an order of the Commission pursuant to Section 6(c) of the Act is respectfully requested exempting the Commingled Account from Sections 10(b)(3) and 10(c) of the Act to the extent of permitting all but one of the members of the Committee to be affiliated persons of the Bank.

B. Action by Participants

It is intended to schedule the first annual meeting of the Participants on a day which is not less than 60 nor more than 90 days after the end of the Commingled Account's first fiscal year. Accordingly, an order of the Commission pursuant to Section 6(c) of the Act is respectfully requested exempting the Commingled Account from the requirements of Sections 15(a), 16(a) and 32(a)(2) of the Act so that the Commingled Account may operate for a limited period without Participant approval of the management agreement, without Participant election of the members of the Committee, and without Participant approval of the selection of independent public accountants, as required, respectively, by the above Sections of the Act, such exemption to

remain effective until action can be taken with respect to these matters by the Participants at the first annual meeting of the Participants.

C. Custodian Arrangements and Bonding

Pursuant to the proposed management agreement with the Bank, the portfolio securities and other assets of the Commingled Account will be placed and maintained in the custody of the Bank, which is a "bank" within the meaning of the Act having the qualifications prescribed in paragraph (1) of Section 26(a) of the Act for the trustees of unit investment trusts, and the members of the Committee will not be authorized or permitted to withdraw such investments upon their mere receipt. However, because the Bank and the Commingled Account may not be deemed to be separate entities, it might be contended that the Commingled Account will be deemed to have placed and maintained its securities and similar investments in its own custody, in which case Rule 17f-2 of the Commission might be deemed to be applicable. Accordingly, in order of the Commission pursuant to Section 6(c) of the Act is respectfully requested exempting the Commingled Account from compliance with Rule 17f-2 of the Commission so long as the securities and other assets of the Commingled Account are placed and maintained in the custody of the Bank pursuant to the provisions of the proposed management agreement or provisions substantially similar thereto.

The Commingled Account will not have officers and employees and, accordingly, it would seem that the provisions of Section 17(g) of the Act and Rule 17g-1 of the Commission are inapplicable. However, because the Bank and the Commingled Account may not be deemed to be separate entities, the provisions of Section 17 (g) of the Act and Rule 17g-1 of the Commission might be deemed to be applicable to the officers and employees of the Bank having access to the securities or funds of the Commingled Account. Accordingly, an order of the Commission pursuant to Section

6(c) of the Act is respectfully requested exempting the Commingled Account from compliance with Rule 17g-1 of the Commission so long as the securities and other assets of the Commingled Account are placed and maintained in the custody of the Bank pursuant to the provisions of the proposed management agreement or provisions substantially similar thereto.

IV. GROUNDS FOR THE REQUESTED ORDER

The exemptions hereby applied for are necessary and appropriate in the public interest and consistent with the protection of investors and the purposes intended by the policy and provisions of the Act. The granting of the exemptions requested under Section 10(c) and 10(d)(2) of the Act will permit the Bank to offer its management services to a larger number of customers without in any way detracting from the protection afforded by the Act to investors. Section 10(d) was expressly included in the Act "to take care of certain types of investment companies which are closely affiliated with investment advisers and which are designed primarily to make available this medium of diversification of investment to the smaller customers of these advisers." Senate Rep. No. 1775, 76th Cong., 3d Sess., p. 14 (1940). These are precisely the aims of the Commingled Account. Unless an exemption from Section 10(c) of the Act is granted, the Bank will be effectively precluded from providing an investment advisory service to customers whose investment funds are not sufficiently large to justify the expense of individual investment management. The failure of the Commingled Account to meet the test of Section 10(d)(2) is merely a technical failure, resulting from the fact that it was not considered necessary to subject banks to the regulatory scheme of the Investment Advisers Act of 1940 and they were therefore exempted.

With respect to the requested exemption from Section 10(b)(3) of the Act, it should be noted that Section 10(f) of

the Act would prohibit purchases for the Commingled Account, during the existence of any underwriting or selling syndicate, of any security a principal underwriter of which is an investment adviser of the Commingled Account. It is intended that the Commingled Account comply with the provisions of Section 10(f) and, accordingly, the choice of investments for the Commingled Account will not be influenced by the fact that the Bank may be a member of underwriting syndicates.

In order to permit the Commingled Account to be established, to register under the Act, to obtain its initial \$100,000 and to have its registration statement on Form S-5 under the Securities Act of 1933 become effective, it will be necessary to organize the Committee, to enter into the management agreement and to select the independent public accountant for the Commingled Account. There will, however, be no Participants (or only a limited number of Participants) during such period and it will therefore not be possible to have such matters acted upon by a significant number of Participants until some time after the effective date of the Commingled Account's registration statement under the Securities Act of 1933. Accordingly, exemption is requested from the provisions of Sections 15(a), 16(a) and 32(a)(2) of the Act for a limited time, with appropriate safeguards. The management agreement with the Bank will be contingent upon approval by a vote of Participants having a majority interest in the Commingled Account at the first annual meeting of Participants, and the provisions of such agreement will be summarized in the Prospectus delivered to each Participant. Similarly, the Participants will have an opportunity to elect the members of the Committee at the first annual meeting and to accept or reject the appointment of the independent public accountants with respect to the Commingled Account's second fiscal year. In similar cases the Commission has issued exemptions for a limited period for new companies unable to comply with

the above provisions of the Act. Accordingly, the granting of these limited exemptions until the first annual meeting of Participants is founded on established practice by the Commission and is necessary and appropriate in the public interest and consistent with protection of investors and the purposes of the Act.

With respect to the exemptions requested under Rules 17f-2 and 17g-1 of the Commission, the Participants will be adequately protected without requiring compliance with the above provisions. The Bank will maintain custody of the investments of the Commingled Account in the same manner in which custody of investments is maintained for other fiduciary accounts of the Bank, and its officers and employees will be adequately bonded. Its procedures and practices in these respects are subject to control and supervision by governmental authorities having supervision over banks.

V. CONSENT TO USE OF THIS DOCUMENT IN EVIDENCE

Pursuant to Rule 0-2(f) of the Commission, the Bank hereby offers this Application and all Exhibits hereto and all amendments hereof hereafter made, in evidence at any hearing with respect to the action herein sought, and requests that the original, a duplicate original, or a photocopy of this Application and any and all amendments hereof, whether executed hereafter or concurrently herewith, be offered in evidence on behalf of the Bank and be received in evidence as an exhibit of the Bank in any such proceeding before the Commission, or any officer thereof or any Trial Examiner designated thereby, and that the verification of this Application and any amendment hereof be considered as if the persons signing such verification had personally appeared and testified orally under oath, duly administered, in any such proceeding to the statements contained in such verification.

VI. AUTHORIZATIONS

Hulbert W. Tripp is authorized to sign and file this Application on behalf of the Bank by virtue of the authority vested in him as a Senior Vice-President of the Bank. Section 8 of Article IV of the By-Laws of the Bank provides in pertinent part as follows:

"The Board of Directors may appoint one or more Senior Vice-Presidents of the Association. Each Senior Vice-President shall have general executive powers, as well as the specific powers conferred by these By-Laws."

Section 2 of Article X of the By-Laws of the Bank provides in pertinent part as follows:

"All agreements, indentures, mortgages, deeds, conveyances, transfers, certificates, declarations, receipts, discharges, releases, satisfaction, settlements, petitions, schedules, accounts, affidavits, bonds, undertakings, proxies and other instruments or documents may be signed, executed, acknowledged, verified, delivered or accepted in behalf of the Association by the Chairman, or the President, or the Chairman of the Executive Committee, or any Vice-Chairman, or any Executive Vice President, or the Chairman Credit Policy Committee, or the Vice-President Operations, or any Senior Vice-President The provisions of this Section 2 are supplementary to any other provision of these By-Laws."

The authority vested in Hulbert W. Tripp as a Senior Vice-President by these provisions of the By-Laws has not been limited in any respect which would detract from his authority to sign and file this Application.

Dated: August 23, 1965

FIRST NATIONAL CITY BANK

/s/ HULBERT W. TRIPP

HULBERT W. TRIPP

Senior Vice-President

STATE OF NEW YORK }
 COUNTY OF NEW YORK } ss.:

The undersigned, being duly sworn, deposes and says that he has duly executed the foregoing Application, dated August 23, 1965, for and on behalf of First National City Bank; that he is a Senior Vice-President of such Bank; and that all corporate action necessary to authorize deponent to execute and file such instrument has been taken. Deponent further says that he is familiar with such instrument, and the contents thereof, and that the facts therein set forth are true to the best of his knowledge, information and belief.

/s/ HULBERT W. TRIPP
 HULBERT W. TRIPP

Subscribed and sworn to
 before me, a Notary Public,
 this 23rd day of August, 1965.

/s/ ANN M. BALSAMO
 ANN M. BALSAMO
 Notary Public
 State of New York
 No. 24-0147535
 Qualified in Kings County
 Cert. Filed in New York County
 Commission Expires March 30, 1967
 [Official Seal]

Exhibit A
PROSPECTUS

DRAFT—August 19, 1965

Prospectus

FIRST NATIONAL CITY BANK
399 Park Avenue
New York, New York

COMMINGLED INVESTMENT ACCOUNT

In order to make its investment advisory services available to a larger number of customers, First National City Bank (the "Bank") accepts custody and investment discretion as to accounts with a minimum amount of \$10,000 pursuant to an agreement signed by the customer authorizing the Bank to invest such funds, together with the funds of other customers who have given the Bank the same authority, in a single collective account (the "Commingled Account") in which each such customer shares in proportion to the amount of his funds which are included.

Supervision and Management

THIS OFFERING HAS NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

Supervision of the Commingled Account is in the hands of a committee (the "Committee") of officers of the Bank together with individual(s) entirely independent of the Bank. The Bank is responsible for the management of the investments in the Commingled Account, as more fully described under the heading "Management Services", and the full facilities and resources of the Bank are avail-

able for investment analysis and research, review of current economic conditions and trends, and consideration of long-range investment policy.

Investment Policy

The policy of the Commingled Account is to invest in securities which offer the opportunity for long-term growth of capital and income. Investments are made principally in common stocks and in securities convertible into common stocks, but, depending upon the Bank's interpretation of business, economic and market conditions, all or part of the funds of the Commingled Account may be invested at any time in other securities, including corporate preferred stocks, bonds, debentures or other evidences of indebtedness, and obligations issued or guaranteed by the United States or an instrumentality thereof.

The funds in the Commingled Account are invested in a carefully selected portfolio diversified among various industries, and it is not intended to concentrate more than 25% of the Commingled Account in investments in any one particular industry. Purchases and sales of securities will be made on the basis of investment considerations and not for short-term profit.

The foregoing investment policies and the investment restrictions stated below may be changed only when permitted by law and consented to by the vote of a majority of the units of participation in the Commingled Account.

Investment Restrictions

Funds in the Commingled Account will not be lent to others, used in the underwriting of securities, applied to the purchase of real estate, commodities or commodity contracts, invested in companies for the purpose of exercising control or management or invested in the securities of investment companies. At least 75% of the portfolio will be represented by cash and cash items, securities issued or

guaranteed by the United States or an instrumentality thereof and securities which, as to any one issuer, do not represent more than 10% of the voting securities of such issuer or more than 5% of the value of the assets in the Commingled Account. The Commingled Account will not engage in margin transactions or short sales, participate in a joint trading account, or borrow money.

The Commingled Account is also subject to applicable rules and regulations of the United States Comptroller of the Currency and to certain provisions of the Investment Company Act of 1940 and the rules and regulations of the Securities and Exchange Commission thereunder, including restrictions on transactions with affiliated persons, on changes in its investment policy and on the investment of its assets in certain specified types of companies. (The registration of the Commingled Account under the Investment Company Act of 1940 does not involve any supervision by the Securities and Exchange Commission of the management or investment practices or policies of the Commingled Account.)

Units of Participation

For convenience in determining the proportionate interest in the Commingled Account of each participating customer ("Participant"), the Commingled Account is divided into units of equal value, and the proportionate interest of each Participant is expressed by the number of such units allocated to such Participant. Each unit represents an equal interest in the Commingled Account and no unit has priority or preference over any other with respect to any liquidation of the Commingled Account or any other rights or privileges. The number of units of participation is not limited. Fractional units are not used. No Participant has or is deemed to have exclusive ownership of any particular asset or investment of the Commingled Account.

A receipt is issued to each Participant showing the units of participation credited to his account. The receipts are not

themselves transferable. Units of participation may be transferred only to persons who have validly appointed the Bank as managing agent, by application to the Bank accompanied by the surrender of receipts for the units to be transferred. Transfer of less than the total participation of a Participant is permitted only if the aggregate net asset value both of the units remaining in the transferor's account after the transfer and of the units to be transferred is not less than \$10,000 each.

Determination of Net Asset Value

The original value of each unit of participation upon the establishment of the Commingled Account was arbitrarily set at \$10, and Participants included prior to 12:00 midnight, New York time, , 1965, acquire one unit for every \$10 invested. Thereafter, the net asset value of each unit is determined as of the close of business on each of the specified valuation dates by dividing the net asset value of the Commingled Account as of the close of business on such valuation date by the number of units of participation then outstanding, the result being adjusted to the nearer cent.

The valuation dates as of which the net asset value of the Commingled Account is determined are: (a) every Tuesday (commencing Tuesday, , 1965), if a day (a "Business Day") on which both the Bank and the New York Stock Exchange are open for business, or if not a Business Day, then the next succeeding day which is a Business Day, (b) any other day (commencing Wednesday, , 1965) as of which the net asset value of the Commingled Account is determined for the purpose of permitting terminations as provided under the heading "Termination of Participations," and (c) in any event, on the last day of , and in each year. The Committee shall be free at any time and from time to time to change the valuation dates described in clause (a) above upon 30 days' notice to the Participants, provided that the frequency of such valuation dates shall

not be decreased to less than a weekly basis without the consent of Participants holding at the time of consent a majority of the units of participation.

The net asset value of the Commingled Account is an amount which reflects calculations made as follows (with estimates used where necessary or appropriate):

(1) A security listed on a national stock exchange is valued at its last sale price on such exchange on the date as of which it is valued, or if such exchange is not open on such date, then at its last sales price on the next preceding date on which such exchange was open. If no sale is reported for such date, the security is valued at an amount not higher than the closing asked price nor lower than the closing bid price.

(2) Securities not listed on a national stock exchange and every other asset of the Commingled Account are valued at their fair market value as of the close of business on the valuation date, determined either by reference to values supplied by a generally accepted pricing or quotation service or by taking into consideration quotations furnished by one or more reputable sources, such as pricing or quotation services, securities dealers, brokers or investment bankers, values of comparable property, appraisals or such other information or circumstances as the Committee considers relevant.

(3) An investment purchased and awaiting payment against delivery is included for valuation purposes as a security held, and the cash account is adjusted to reflect the purchase price, including brokers' commissions and other expenses incurred in the purchase thereof but not disbursed as of the valuation date.

(4) An investment sold but not delivered pending receipt of proceeds is valued at the net sales price.

(5) Brokers' commissions, taxes and other expenses which may be incurred in connection with the future purchase or sale of portfolio securities as a result of

admissions to or terminations of participations occurring as of the valuation date are not considered in valuing the assets of the Commingled Account as of such valuation date.

(6) Uninvested cash is valued at its face amount.

(7) The value of any dividends, including stock dividends, or rights which may have been declared on securities in the portfolio but not received by the Commingled Account as of the close of business on the valuation date are included as an asset of the Commingled Account if the security upon which such dividends or rights were declared is included and is valued ex-dividend or ex-rights.

(8) Interest accrued on any interest-bearing security in the portfolio is included as an asset of the Commingled Account if such accrued interest is not otherwise included in the valuation of the underlying security. Other accrued income is also included to the date of calculation.

(9) All reserves, liabilities, expenses, taxes and other charges due or accrued which in the discretion of the Committee are properly chargeable to the Commingled Account up to the date of calculation are deducted. An estimate of the fee chargeable by the Bank for investment management and other services and accrued to date is included as an expense.

(10) Each admission to and termination of a participation is reflected no later than in the calculation of net asset value as of the first valuation date following the valuation date as of which such admission or termination takes place, but no such admission or termination taking place as of a valuation date is taken into consideration in the calculation of net asset value for such date.

The computation of the net asset value of the Commingled Account and of the units of participation as of each valuation date is completed within the two Business Days next following such date.

Admission to the Commingled Account

Each admission to participation in the Commingled Account is made on the day the written request of the Bank for such admission is received by the Committee, if such day is both a valuation date and a Business Day, or, if such day is not both a valuation date and a Business Day, on the next succeeding day which is both, and is made on the basis of the net asset value of the units of participation as determined for such valuation date.

The minimum acceptable initial participation by any Participant is the largest number of full units that can be acquired for \$10,000. Except for units of participation acquired upon a distribution of net long-term capital gains (see "Distributions and Federal Tax Status"), each subsequent additional participation acquired by a Participant must be at least the largest number of full units that can be acquired for \$1,000. In no event, however, will a participation be accepted if as a result of such investment the Participant would hold units of participation the aggregate net asset value of which would exceed either (a) \$500,000 or (b) 10% of the then net asset value of the Commingled Account.

Termination of Participations

A participation may be terminated in whole or in part, on the basis of the net asset value of the units of participation being terminated and without any charge for termination, pursuant to an irrevocable written notice of termination, accompanied by the receipt or receipts issued to the Participant with respect to the units of participation being terminated, delivered to any office of the Bank on any day

on which the Bank is open for business. However, no Participant may terminate less than all of his units of participation in any case where the aggregate net asset value of the units remaining would be less than \$10,000. If delivery of a notice of termination, accompanied by the receipt or receipts issued with respect to the units of participation being terminated, is made before 1:00 P.M. (New York City time) on a Business Day, the net asset value is determined as of the close of business on that day. If such delivery is made after 1:00 P.M. on a day which is a Business Day or is made at any time during a day when the Bank is open but the New York Stock Exchange is not open, the net asset value is determined as of the close of business on the next day on which the New York Stock Exchange is open. The value of units of participation on termination may be more or less than the Participant's cost, depending on the market value of the securities held by the Commingled Account at the time of termination.

If the Bank is notified of the death or adjudicated incompetency of any Participant, such notification shall be treated as a notice of termination of the participation owned by such Participant. Such notice of termination need not be accompanied by the receipt or receipts issued to the Participant with respect to the units of participation being terminated, but the Bank shall use its best efforts to have such receipt or receipts surrendered as soon as reasonably practicable thereafter.

Distributions upon termination of participations normally will be made in cash within seven days of the day on which the notice of such termination is delivered to the Bank. However, if in its sole discretion the Committee deems it advisable or necessary, such distributions may be made ratably in kind, or partly in cash and partly ratably in kind, provided that all distributions as of any one valuation date are made on the same basis. In addition, the right to terminate a participation or to receive a distribution with respect to any such termination within seven days

as stated above may be suspended for any period during which trading on the New York Stock Exchange is restricted or such Exchange is closed (other than customary weekend and holiday closing), for any period during which an emergency exists as a result of which disposal of portfolio securities or determination of the net asset value of the Commingled Account is not reasonably practicable, and for such other periods as the Securities and Exchange Commission may by order permit. If at the time of any suspension of the right to receive distributions a Participant shall have given a notice of termination but shall not yet have received a distribution, such Participant shall have the right to withdraw the notice of termination.

Distributions and Federal Tax Status

Cash distributions from the net investment income of the Commingled Account will be made to the Participants, ratably on their units of participation, at least quarterly. It is the policy of the Committee to distribute each year substantially all of the net income (including the excess, if any, of net short-term capital gain over net long-term capital loss) of the Commingled Account. For Federal income tax purposes, each such distribution will be taxable to each Participant as ordinary income.

Distribution of net long-term capital gains realized from the sales of securities in the Commingled Account will be made to Participants, ratably on their units of participation, on an annual basis shortly before or after

, the end of the Commingled Account's fiscal year. Such distributions will be paid in full units of participation taken at their net asset value (with any balance payable in cash) unless the Participant elects to receive payment entirely in cash, and will be taxable to each Participant, whether taken in units of participation or in cash, as long-term capital gain irrespective of the length of time he has been a Participant. To the extent that the net asset value of units of participation is reduced below a Participant's cost by distribution of net long-term capital gain

realized on the sale of securities, such distribution is in effect a return of capital, although taxable as stated above. Distributions of net long-term capital gain are not eligible for the \$100 dividend-received exclusion.

The Commingled Account expects to qualify as a "regulated investment company" within the meaning of the Internal Revenue Code. (Such regulation does not involve supervision of management or investment practices or policies.) As such, and by complying with the provisions of the Code applicable to regulated investment companies, the Commingled Account will be relieved of liability for Federal income tax on net income and net long-term capital gains which are distributed.

Management Services

The Commingled Account is managed by the Bank Pursuant to a management agreement (subject to the approval of the Participants at their first annual meeting, scheduled for , 1966). The agreement provides that the Bank will maintain a continuous investment program for the Commingled Account, not inconsistent with its stated investment policy. The Bank will determine what securities are to be purchased or sold for the Commingled Account and will execute transactions for the Commingled Account accordingly. The agreement further provides that the Bank agrees to furnish all custodian, administrative and clerical services, office space and facilities required for the operation of the Commingled Account and to reimburse the Commingled Account for the compensation and expenses, if any, paid by the Commingled Account to the members of the Committee. The Bank also agrees to pay all costs and expenses arising in connection with the organization of the Commingled Account, including its initial registration and qualification under the Federal securities laws and under other applicable regulatory requirements, but the cost of maintaining such registration and qualification (other than the cost of printing, publication and distribution

of current reports to Participants, which will be paid by the Bank) will be an expense of the Commingled Account. The cost of independent professional services, such as legal, auditing or accounting services (other than in connection with the organization of the Commingled Account), and the cost of preparation and distribution of notices to Participants and proxy statements will also be expenses of the Commingled Account.

For the Bank's services, the Commingled Account is charged as of the last day of each fiscal quarter with a fee payable to the Bank equal to $\frac{1}{8}$ th of 1% of the average of the net asset values of the Commingled Account taken on each valuation date during such quarter.

The management agreement is renewable annually after , 1967, provided that such continuance is approved annually by the Committee, including a majority of the members of the Committee who are not directors, officers or employees of the Bank, or by the vote of Participants having a majority of the units of participation. The agreement may, on sixty days' notice, be terminated by the Committee, by the vote of Participants having a majority of the units of participation, or by the Bank, and will terminate automatically if assigned by the Bank. Amendments of the agreement must have the approval of the Comptroller of the Currency.

Members of the Committee

The members of the Committee and their principal occupations during the past five years are as follows:

<i>Name</i>	<i>Address</i>	<i>Principal Occupations</i>
-------------	----------------	----------------------------------

No compensation is paid out of the Commingled Account to any of the members of the Committee who are affiliated with the Bank. Compensation may be paid to the members

of the Committee who are not affiliated with the Bank, but the Commingled Account will be reimbursed by the Bank.

Meetings of Participants

A meeting of Participants for electing members of the Committee and approving the appointment of auditors for the year and for transacting other business is held annually at A.M. on the first in , if not a legal holiday, or, if a legal holiday, then on the next succeeding day not a legal holiday. Special meetings of Participants may be called at any time by any member of the Committee.

All Participants' meetings are held at 399 Park Avenue, New York City, unless a different place of meeting within the City of New York is specified in the notice of the meeting. Notice of the time, place and purpose or purposes of each meeting is mailed, at least 20 days, but not more than 50 days, prior to the meeting, to each Participant, at his address as it appears on the books of the Bank at the time of such mailing, except that persons becoming Participants after the mailing of such notice shall receive notice of the meeting at the time they become Participants. Notice of any adjourned meeting need not be given.

Each Participant is at every meeting of Participants entitled to one vote in person or by proxy for each unit of participation held by such Participant.

Except as otherwise required by provisions of the Investment Company Act of 1940, all matters (other than the election of members of the Committee) are decided by a vote of the majority of the votes validly cast. The vote upon any question is by ballot whenever requested by any Participant but, unless such a request is made, voting may be conducted in any way approved by the meeting. The right to vote by proxy exists only if the instrument authorizing such proxy to act has been executed in writing by the Participant or by his duly authorized attorney.

The presence at any Participant's meeting, in person or by proxy, of Participants holding units of participation aggregating a majority of the total number of units constitutes a quorum for the transaction of business. In the absence of a quorum, a majority in interest of the Participants present in person or by proxy, or if no Participant is present in person or by proxy, any member of the Committee present, may adjourn the meeting *sine die* or from time to time. Any business that might have been transacted at the meeting originally called may be transacted at any adjourned meeting at which a quorum is present.

Election of Members of the Committee

The Committee consists of members, which number may be increased or decreased by resolution of the Committee or action of the Participants, provided that the number of members shall not be less than three. Each member (whenever elected) holds office until his successor has been elected and qualified unless he resigns or his office becomes vacant by his death or removal.

At least one member of the Committee at all times shall be a person who is not affiliated with the Bank. The members of the Committee are elected annually, by a plurality of the votes cast at such election, at the annual meeting of Participants, or, in the event of any failure to elect the members at the annual meeting, at a special meeting of Participants, provided that the notice of such special meeting shall mention such purpose.

If any vacancy occurs in the Committee by reason of death, resignation, removal or otherwise, or if the authorized number of members of the Committee is increased, the members then in office continue to act, and such vacancies or newly created memberships (if not previously filled by the Participants at an annual or special meeting) may be filled by a majority vote of the members then in office, although less than a quorum, provided that immediately after

filling such vacancy at least two-thirds of the members then holding office have been elected to such office by the Participants. In the event that at any time (other than the time preceding the first annual meeting of Participants) less than a majority of the members holding office at that time were so elected by the Participants, a meeting of the Participants shall be held promptly, and in any event within 60 days, for the purpose of electing members to fill any existing vacancies in the Committee unless the Securities and Exchange Commission shall by order extend such period.

Accounting Records, Audits and Financial Reports

The accounting records of the Commingled Account are kept on the basis of a fiscal year ending on the last day of of each year.

At least semiannually, the accounting records of the Commingled Account are audited by Haskins & Sells, or other independent public accountants selected in accordance with the provisions of the Investment Company Act of 1940. The compensation and expenses of the auditors are charged against and payable out of the assets of the Commingled Account.

The Commingled Account, at least semiannually, transmits to Participants reports, based on the audit, containing such financial statements and other information as is required by applicable laws and regulations. The cost of printing, publication and distribution of such reports to Participants is borne by the Bank.

Termination of the Commingled Account

The Commingled Account will continue without limitation of time, provided that the Committee may, if authorized by the vote of Participants having a majority of the units of participation, at any time terminate the Commingled Account. Thereafter, no further moneys shall be admitted to a participation and no terminations shall be permitted,

and the Committee shall, after all expenses and liabilities of the Commingled Account are paid or satisfied, distribute at one time or from time to time the assets of the Commingled Account to the Participants, either in cash or ratably in kind, or partly in cash and partly in kind, provided that all distributions as of any one date shall be made on the same basis.

Status of Commingled Account

The Commingled Account was established in the State of New York on , 1965 and is operated as a collective investment fund pursuant to applicable regulations of the Comptroller of the Currency. The Commingled Account is also deemed to be a diversified, open-end management company within the meaning of the Investment Company Act of 1940.

, 1965

Members of the Committee

Exhibit B

MANAGEMENT AGREEMENT

DRAFT—April 12, 1965

FIRST NATIONAL CITY BANK

, 1965

To: Committee for Commingled Investment Account

This will confirm the arrangements for management, supervision and custody of the funds of customers invested through the Commingled Investment Account (the "Commingled Account"), as follows:

1. *Investment Management Services.* First National City Bank (the "Bank") will manage the investment and re-investment of funds in the Commingled Account. Specific-

ally, the Bank will maintain a continuous investment program for the Commingled Account, not inconsistent with its investment policy as set forth in the registration statement of the Commingled Account, as from time to time amended, under the Investment Company Act of 1940 and in the prospectus of the Commingled Account currently in use under the Securities Act of 1933. The Bank will determine what securities are to be purchased or sold for the Commingled Account and will execute transactions for the Commingled Account accordingly. The Commingled Account will have the benefit of the investment analysis and research, the review of current economic conditions and trends and the consideration of long-range investment policy now generally available to investment advisory customers of the Bank. The Bank will determine what portion, if any, of the Commingled Account should be held uninvested and what portion, if any, should be invested in Government obligations.

2. *Allocation of Costs and Expenses.* Members of your Committee who are officers or employees of the Bank shall receive no separate compensation for their services for the Commingled Account. The Bank shall, however, reimburse the Commingled Account for such compensation and expenses, if any, as the Committee shall have authorized to be paid out of the Commingled Account to any member who is not an officer or employee of the Bank. The Bank will furnish, without expense to the Commingled Account, such administrative and clerical services, including the calculations of asset value, that are required to be made for the Commingled Account, and such office space and facilities as may be required, and will maintain up-to-date records of the Participants in the Commingled Account, their addresses and the extent of their participations. Except to the extent required by the Comptroller of the Currency to be paid by the Bank, the following amounts will be paid directly from the Commingled Account:

- (a) brokers' commissions,
- (b) cost of independent professional services, such as legal, auditing or accounting services,
- (c) taxes or governmental fees attributable to transactions for the Commingled Account or to income from Commingled Account assets,
- (d) cost of maintaining the registration and qualification of the Commingled Account under laws administered by the Securities and Exchange Commission or under other applicable regulatory requirements (except that the cost of printing, publication and distribution of current reports to Participants will be paid by the Bank), and
- (e) cost of preparation and distribution of notices to Participants and proxy statements.

The Commingled Account shall in no event be charged with any costs, fees or other expenses arising in connection with the organization of the Commingled Account, including its initial registration and qualification under the Investment Company Act of 1940 and under the Securities Act of 1933, the initial determination of its tax status and any rulings obtained for this purpose, its qualification under the laws of any State or its approval by the United States Comptroller of the Currency or any other Federal authority, and all of such costs, fees and expenses have been or will be paid by the Bank.

3. *Custody and Safekeeping.* The Bank will have custody of and keep safely at all times the assets of the Commingled Account. Securities included among such assets (other than bearer securities) shall be registered in the name of the Bank or one of its registered nominees, with or without indication of fiduciary capacity. The Bank shall be fully responsible for the fidelity and liabilities of any such nominee.

4. *Transactions in the Account.* All transactions of purchase or sale for the Commingled Account shall be promptly reported to the Committee by the Bank. Except for (i) exchanges of securities held in the Commingled Account for other securities in connection with any properly authorized reorganization, recapitalization, merger, consolidation, split-up or combination of shares, change of par value, conversion or otherwise, (ii) any exchange of securities in temporary form for securities in definitive form, (iii) the surrender of bonds or other obligations at maturity or when called for redemption, or (iv) the surrender of securities to representatives of all holders of securities of the same class for their protection in reorganization or similar proceedings, securities held for the Commingled Account shall be delivered only against payment

(a) in lawful money of the United States paid to the Bank or its agent,

(b) by certified check upon, or treasurer's or cashier's check of, a New York bank delivered to the Bank or its agent, or

(c) if delivery is made in New York, by credit to the account of the Bank or its agent by the New York Stock Clearing Corporation,

provided, however, that the Bank or its agent may accept an uncertified check in the case of any transaction where the payment involved does not exceed \$1,000. Orders to sell securities for the Commingled Account will be placed only with established brokers or dealers. The Bank will maintain in its Custodian Department one or more cash accounts, identified as assets of the Commingled Account and subject only to draft or order by the Bank as custodian or agent. All monies received by the Bank or for the Commingled Account shall be deposited in said account or accounts.

5. *Collections.* The Bank will collect, receive and deposit for the Commingled Account all income and other payments with respect to the securities in the Commingled Account, will execute ownership and other certificates and affidavits for all federal, state or local tax purposes, and will take all other action necessary in connection with the collection, receipt and deposit of such income and other payments, including but not limited to the presentation for the payment of all coupons and other income items requiring presentation on all securities which may mature or be called, redeemed, retired or otherwise become payable and the endorsement for collection by the Commingled Account of all checks, drafts or other negotiable instruments. The Bank will receive and collect all stock dividends, rights and other similar items.

6. *Distributions to Participants.* The Bank will, in accordance with instructions of the Committee, act as paying or disbursing agent for all funds distributed to Participants whether as income, profits, amounts payable on termination, or otherwise.

7. *Proxies, Notices, etc.* The Bank will promptly transmit to the Committee all notices, proxy forms and proxy statements and all other requests and announcements furnished to the Bank or its nominee as registered holder of securities in the Commingled Account and will execute and deliver or cause its nominee to execute and deliver such proxies or other authorizations in such manner as the Committee shall direct.

8. *Disbursements.* In so far as funds are available in the Commingled Account for the purpose, the Bank will disburse from such funds amounts required to pay such bills, statements and other obligations as are payable out of the Commingled Account pursuant to the provisions of paragraph 2 hereof or as are otherwise approved by the Committee, such approval to be evidenced by the record of the minutes

of a meeting of the Committee or by the signature of two members thereof.

9. *Books, Records and Accounts.* The Bank will maintain proper books of account and complete records of all transactions in the Commingled Account (whether in the investment account or the deposit account) and will render statements or copies thereof from time to time as requested by the Committee or as may otherwise be required by law. The Bank will assist in the preparation of reports to Participants, to the Securities and Exchange Commission, to the Comptroller of the Currency and to others, and in all audits of the Commingled Account.

10. *Compensation of the Bank.* For all services to be rendered and payments to be made by the Bank as described in this agreement, the Bank shall be entitled to withdraw from the Commingled Account as of the last day of each fiscal quarter and pay to itself a fee of $\frac{1}{8}$ th of 1% of the average of the net asset values of the Commingled Account taken on each valuation date throughout the quarter for purposes of determining the asset value of units of participation, and no more. If for any reason the determination of such asset value has been lawfully suspended for a period including any such quarter, the Bank's compensation payable at the end of such quarter shall be computed on the basis of the value of the net assets in the Commingled Account as last determined prior to such quarter.

11. *Avoidance of Inconsistent Positions.* In connection with purchases or sales of securities for the Commingled Account, neither the Bank nor any of its directors, officers or employees will act as a principal or agent or receive any commissions. The Bank will not itself become a Participant in the Commingled Account. Where the Bank is called upon to give advice to its customers concerning the Commingled Account, it will act solely as investment adviser for such customers with disclosure of the position of the Bank with respect to the Commingled Account.

12. *Duration and Termination.* This Agreement shall remain in force until _____, 1967, and from year to year thereafter, but only so long as such continuance is approved at least annually either by the committee, including specific approval by a majority of the Committee who are not persons affiliated with the Bank, or by the vote of Participants having a majority interest in the Commingled Account. This agreement may, on 60 days' prior written notice, be terminated at any time without the payment of any penalty, by the Committee, by the vote of Participants having a majority interest in the Commingled Account, or by the Bank. This agreement shall automatically terminate in the event of its assignment by the Bank or if it shall not be approved by Participants having a majority interest in the Commingled Account at the first meeting of the Participants. In interpreting the provisions of this paragraph 12, the definitions contained in Section 2(a) of the Investment Company Act of 1940 (particularly the definitions of "affiliated person" and "assignment") shall be applied, except that a "majority interest" in the Commingled Account shall mean more than 50% of the units of participation into which the Commingled Account is at the time divided.

13. *Amendments Hereof.* No provision of this agreement may be changed, waived, discharged or terminated orally, but only by an instrument in writing signed by the Bank, and no amendment of this agreement shall be effective until approved by the vote of Participants having a majority interest in the Commingled Account.

If the foregoing conforms to your understanding of the arrangements, please so indicate by signing the form of acceptance on the accompanying counterpart hereof.

FIRST NATIONAL CITY BANK
By _____

The foregoing is confirmed and accepted as of the date thereof.

ADMINISTRATIVE PROCEEDING FILE No. 3-280
Securities & Exchange Comm. Mailed for Service
Sept. 7, 1965

No. 810783 thru 810786

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

SEPTEMBER 2, 1965

Notice of Filing of Application Pursuant To Section 6(c) For
An Order of Exemption From Sections 10(b)(3), 10(c),
10(d)(2), 15(a), 16(a), 17(f), 17(g) and 32(a)(2) of The In-
vestment Company Act of 1940.

In the Matter of

FIRST NATIONAL CITY BANK
(Commingled Investment Account)
399 Park Avenue
New York, New York 10022
(812-1823)

Investment Company Act of 1940

NOTICE IS HEREBY GIVEN that First National City Bank ("Bank"), a national banking association, has filed an application on behalf of its proposed Commingled Investment Account ("Commingled Account") pursuant to Section 6(c) of the Investment Company Act of 1940 ("Act") for an order exempting the Commingled Account from the provisions of Sections 10(b) (3), 10(c), 10(d) (2), 15 (a), 16(a), 17(f), 17(g), and 32(a) (2) of the Act. All interested persons are referred to the application on file with the Commission for a statement of the representations therein which are summarized below.

The Bank represents that prior to the issuance of any order pursuant to Section 6(c) of the Act with respect to any exemption requested in its application, the Commingled

Account will be registered under the Act. Upon registration and grant of the requested order, the Commingled Account will operate as a diversified open-end management investment company and as a collective investment fund pursuant to applicable regulations of the Comptroller of the Currency.

The Bank proposes to accept custody of and investment discretion with respect to minimum accounts of \$10,000 pursuant to an agreement signed by customers authorizing the Bank to invest such funds in the Commingled Account. The Commingled Account will be divided into units of equal value, and the proportionate interest of each participating customer ("Participant") will be expressed by the number of such units allocated thereto.

Following registration under the Act, the initial \$100,000 required by Section 14(a) of the Act will be obtained through a private offering to a small group of persons intending to acquire such units for investment. Following the effective date of the registration of units of the Commingled Account under the Securities Act of 1933, moneys of customers of the Bank will be added to the Commingled Account as of specified valuation dates, their accounts being credited with units of participation at the then net asset value of such units.

The Commingled Account will have no underwriter. The Bank will, as agent for each customer who has signed the required authorization, take the necessary steps to have the customer's moneys admitted to the Commingled Account.

The operation of the Commingled Account will be subject to the supervision of a committee of at least three persons ("Committee"), one of whom will not be affiliated with the Bank. Initially, the members of the Committee will be appointed by the Bank. Thereafter, the members of the Committee will be elected by the Participants at annual

meetings. It is expected that the first annual meeting of the Participants will be held not less than 60 days after the end of the Commingled Account's first fiscal year.

Prior to the commencement of operation of the Commingled Account, it is expected that the Committee will enter into a management agreement with the Bank, subject to the approval of the Participants at their first annual meeting. Pursuant to the agreement the Bank will maintain a continuous investment program, will determine what securities are to be purchased or sold, and will execute transactions, for the Commingled Account. The Bank will furnish administrative and clerical services required for the operation of the Commingled Account, and will act as custodian of the securities and other assets of the Commingled Account. The commingled account itself will have no officers or employees.

It is expected that the Committee will select, within 30 days of the establishment of the Commingled Account and with the concurrence of members of the Committee who are not affiliated with the Bank, a firm of independent public accountants as the accountants for the Commingled Account's first fiscal year. It is expected that within 30 days before or after the beginning of the second fiscal year, the selection of the accountants will be renewed by the Committee for such fiscal year. The selection of the accountants for the second fiscal year will be submitted for ratification or rejection at the first annual meeting of the Participants.

Section 10(b) (3) of the Act provides that no registered investment company shall have as a director, officer, or employee, any investment banker, or any affiliated person of an investment banker, unless a majority of the board of directors of such registered company shall be persons who are not investment bankers or affiliated persons of any investment banker. Since the Bank may be deemed to be an "investment banker" as defined in Section 2(a) (20) of the

Act in that it participates from time to time in syndicates underwriting U.S. Government and municipal obligations, the Bank has requested an order exempting the Commingled Account from compliance with Section 10 (b) (3) of the Act.

Section 10(c) of the Act provides that no registered investment company shall have a majority of its board of directors consisting of persons who are officers or directors of any one bank. Since the Bank is a "bank" within the meaning of Section 2(a) (5) of the Act, an exemption from the provisions of Section 10(c) is requested.

Section 10(d) of the Act provides that a registered investment company may have a board of directors all the members of which, except one, are affiliated persons of the investment adviser of such company, or are officers or employees of such company, if certain conditions are met. One of these conditions (Section 10(d)(2)), is that such investment adviser be registered under the Investment Advisers Act of 1940 and be engaged principally in the business of rendering investment supervisory services as therein defined. Since the Bank is by definition not an "investment adviser" within the meaning of Section 202(a) (11) of the Investment Advisers Act of 1940 it therefore cannot register under that Act. Accordingly, the Bank has requested an order of the Commission exempting the Commingled Account from compliance with Section 10(d)(2) of the Act so long as the Bank shall be acting as investment adviser to the Commingled Account. The Commingled Account will comply with the other provisions of Section 10(d) of the Act so that all members of the Committee except one may be affiliated persons of the Bank, which will be the Commingled Account's investment adviser.

In order that the Commingled Account may operate for a limited period of time without Participant approval of the management agreement, without Participant election

of the members of the Committee, and without Participant approval of the selection of the independent public accountants, as required by Sections 15(a), 16(a) and 32(a) (2) of the Act, the Bank has requested an order of the Commission exempting the Commingled Account from compliance with the above sections of the Act. The Bank requests that such exemption remain effective until action can be taken with respect to these matters by the Participants at the first annual meeting of the Participants.

Section 17(f) of the Act requires every registered management investment company to place and maintain its securities and investments in the custody of a bank or in its own custody, but in the latter event only in accordance with such rules, regulations or orders as the Commission shall prescribe in the interests of investors. Rule 17f-2 under the Act prescribes the conditions under which a registered management investment company shall maintain its securities and investments in its own custody including their deposits in a bank for safekeeping. Pursuant to the proposed Management Agreement with the Bank, the securities and investments of the Commingled Account will be deposited in the Bank for safekeeping. The Bank has requested an order of the Commission exempting the Commingled Account from compliance with Rule 17f-2 to the extent that the Rule might require that the securities and investments of the Commingled Account be deposited for safekeeping in a bank other than the First National City Bank.

Section 17(g) of the Act provides that the Commission is authorized to require that any officer and employee of a registered investment company who may singly, or jointly with others, have access to securities or funds of any registered investment company be bonded by a reputable fidelity insurance company in such reasonable minimum amounts as the Commission may prescribe. Rule 17g-1 under Act prescribes the manner in which the amount of such bonds

is to be determined and requires certain filings and the giving of certain notices. The Bank has requested an order of the Commission exempting the Commingled Account from compliance with Rule 17g-1 to the extent that the Rule might require that the officers and employees of the Bank having access to the securities or funds of the Commingled Account be placed under a bond in compliance with the Rule. The Bank requests that such exemption remain effective so long as the securities and other assets of the Commingled Account are placed and maintained in the custody of the Bank whose officers and employees are subject to control and supervision in these respects by other governmental authorities having supervision over banks.

Section 6(c) of the Act provides, among other things, that the Commission, by order upon application, may conditionally or unconditionally exempt any person from any provision or provisions of the Act or of the rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

NOTICE IS FURTHER GIVEN that any interested person may, not later than September 20, 1965, at 5:30 P.M., submit to the Commission in writing a request for a hearing on the matter accompanied by a statement as to the nature of his interest, the reason for such request and the issues, if any, of fact or law proposed to be controverted, or he may request that he be notified if the Commission should order a hearing thereon. Any such communication should be addressed: Secretary, Securities and Exchange Commission, Washington, D.C. 20549. A copy of such request shall be served personally or by mail (air mail if the person being served is located more than 500 miles from the point of mailing) upon applicant at the address stated above. Proof of such service (by affidavit or in case of an attorney-at-law by certificate) shall be filed contemporaneously with

the request. At any time after said date as provided by Rule 0-5 of the Rules and Regulations promulgated under the Act, an order disposing of the matter herein may be issued by the Commission upon the basis of the information stated in the application, unless an order for hearing upon said proposal shall be issued upon request or upon the Commission's own motion.

IT IS ORDERED that the Secretary of the Commission shall send a copy of this notice by certified mail to the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation.

By the Commission.

ORVAL L. DuBOIS
Secretary

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

OCTOBER 20, 1965

Order Establishing The Procedure For The Filing of Briefs
And The Presentation of Oral Argument Respecting An
Application For An Order of Exemption From Certain
Sections of The Investment Company Act of 1940.

In the Matter of

FIRST NATIONAL CITY BANK
(Commingled Investment Account)
399 Park Avenue
New York, New York 10022
(812-1823)

Investment Company Act of 1940

The First National City Bank ("Bank"), a national banking association, has filed an application on behalf of its proposed Commingled Investment Account ("Commingled Account") pursuant to Section 6(c) of the Invest-

ment Company Act of 1940 ("Act") for an order exempting the Commingled Account from the provisions of Sections 10(b) (3), 10(c), 10(d) (2), 15(a), 16(a), 17(f), 17(g) and 32(a) (2) of the Act.

The Commission on September 2, 1965, issued a notice of the filing of said application (Investment Company Act Release No. 4342). The notice, which is incorporated herein by reference, gave interested persons an opportunity to request a hearing and stated that an order disposing of the application might be issued upon the basis of the information stated therein unless a hearing should be ordered.

The Investment Company Institute ("ICI"), the National Association of Securities Dealers ("NASD"), and the Association of Mutual Fund Plan Sponsors, Inc. ("Association") have each filed a request for a hearing. The requests indicate that no evidentiary hearing is desired but each seeks the opportunity to file a brief in support of its position opposing the grant of the application. The Bank has similarly indicated it does not desire an evidentiary hearing. Without passing on the question, urged by the Bank, that none of the organizations has standing to request a hearing or to participate in the proceeding, the Commission hereby permits the organizations to file briefs and to present oral argument if oral argument is subsequently ordered.

IT IS THEREFORE ORDERED that the Division of Corporate Regulation, the Bank, ICI, NASD and the Association may file briefs bearing upon the disputed points of law not later than November 22, 1965.

Reply briefs may then be filed not later than December 7, 1965.

By the Commission.

ORVAL L. DuBOIS
Secretary

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

In the Matter of

FIRST NATIONAL CITY BANK
(Commingled Investment Account)
399 Park Avenue
New York, New York 10022
(File No. 812-1823)

(Investment Company Act of 1940)

Motion For Amendent

The National Association of Securities Dealers, Inc., a participant in these proceedings, hereby moves the Commission, pursuant to Rule VI (d) of the Rules of Practice, to amend the Notice of Filing of Application in this proceeding, date September 2, 1965 (Investment Company Act Release No. 4342), to amend, modify, supplement or amplify the following statement in that Notice (at p. 2): "The operation of the Commingled Account will be subject to the supervision of a committee of at least three persons ("Committee"), one of whom will not be affiliated with the Bank."

The action herein requested will require the Commission to direct the applicant, consistent with Rule XXI (d), to amend the Application to state matters contained in the brief it filed on November 22, 1965, and relate those matters to the above quoted statement which was based on the applicant's representation in its Application.

Because of its importance and its impact on the reply briefs to be filed, it is further requested that the Commission extend the time for filing reply briefs (now set for

December 21, 1965) until three weeks after the relief herein requested has been effectuated.

Respectfully submitted,

MARC A. WHITE
Marc A. White
General Counsel,
National Association of
Securities Dealers, Inc.
888 - 17th Street, N. W.
Washington, D. C. 20006

JOSEPH B. LEVIN
Joseph B. Levin
Brown Lund & Levin
1625 Eye Street, N. W.
Washington, D. C. 20006
Of Counsel

December 8, 1965

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION
DECEMBER 17, 1965
Order Denying Motion And Granting Extension
In the Matter of
FIRST NATIONAL CITY BANK
(Commingled Investment Account)
(812-1823)
Investment Company Act of 1940

The National Association of Securities Dealers, Inc. ("NASD") filed a motion requesting that the Notice of Filing of Application in the above proceedings be amended with respect to the statement describing the operation of the Commingled Investment Account proposed under the

Application as filed by the First National City Bank ("Bank"). The NASD further requested an extension of time in which to file reply briefs. The NASD filed a brief in support of its motion, the applicant and the Division of Corporate Regulation ("Division") filed answering briefs and the NASD filed a reply brief.

The NASD contended that in the absence of the amendment desired by it the record in the proceedings was factually inadequate to determine the issues raised because of the asserted lack of specificity, in the Application and the Notice, with respect to the nature of the supervision over the Commingled Investment Account which would be exercised by the Committee to be initially appointed by the applicant and subsequently elected by the participants in that Account.

The applicant and the Division urged that the papers submitted in the case supplied an adequate basis for going forward to a determination of the legal issues raised. The Division further asserted that the NASD's position with respect to the role of the Committee and the Bank could be adequately presented without the amendment sought by including its arguments concerning the supervision of the Commingled Investment Account in its reply brief. The applicant and the Division expressed the view that it was undesirable to delay the proceedings by extending the time for filing reply briefs as requested.

The Commission noted that the Application and the exhibits attached thereto, consisting of copies of the proposed Prospectus relating to the Commingled Investment Account and of the proposed management agreement between the Committee and the Bank, contained a description of the operation of the Account. It also noted that applicant had submitted with its brief on the motion a copy of a letter of the Comptroller of the Currency setting out the principal features of the proposed arrangement between

the Bank and the Account and approving such arrangement, and the Commission directed that such letter be deemed a part of the record in the proceedings.

The Commission was of the opinion that it appeared that the amendment requested was not necessary for a resolution of the issues raised by the application, and that the reply briefs would afford adequate opportunity for the presentation of any relevant arguments with respect to the operation of the Account and the roles of the Committee and the Bank. It accordingly denied the motion, and it granted an extension of time to December 28, 1965 for the filing of reply briefs on the merits.

By the Commission.

ORVAL L. DuBois
Orval L. Dubois
Secretary

Exhibit A

THE COMPTROLLER OF THE CURRENCY
THE ADMINISTRATOR OF NATIONAL BANKS
WASHINGTON

May 10, 1965

Mr. Robert L. Hoguet, Jr.
Executive Vice President
First National City Bank
399 Park Avenue
New York, New York

Dear Mr. Hoguet:

This is in reply to your request of April 26 for our approval of an arrangement to be entered into by the bank whereby funds of agency accounts which confer investment discretion on the bank are to be invested and reinvested in a single commingled account.

More specifically, the principal features of the arrangement are as follows:

The funds of certain agency accounts of at least \$10,000 in amount will be commingled for investment purposes. Funds deposited with the bank for this purpose will be accompanied by a broad authorization to the bank, substantially equivalent to the power of attorney under which customers currently deposit their funds for individual attention.

The availability of the commingled account will not be given publicity by the bank except in connection with the promotion of its fiduciary services in general and the bank will not advertise or publicize the commingled account as such. Participations in the commingled account are to be made available only on the premises of the bank and its branches, or to persons who are already customers of the bank in other connections, or in response to unsolicited requests.

The Plan of the commingled account and the letter of authorization signed by the customer will be delivered to each customer of the bank who empowers the bank to invest his funds in the commingled account.

The commingled account will operate as follows. The supervision of the commingled account will be in the hands of a committee, the members of which will initially be appointed by the bank but thereafter elected by the participants at annual meetings. It is expected that officers of the bank will be members of the committee, except that at all times there will be at least one member who is independent of the bank. Pursuant to a management agreement with the committee, the bank will be responsible for the management of the investments in the commingled account, will have custody of the assets in the commingled account, will handle all transactions in the portfolio of the com-

mingled account, and will maintain the records and keep the books of the commingled account.

The management agreement shall be subject to the approval of the participants at their first annual meeting. The management agreement will remain in force for two years from the date of its execution and is renewable annually thereafter, provided that such continuance is approved annually by the committee, including a majority of the members of the committee who are not directors, officers, or employees of the bank, or by vote of participants having a majority of units of participation. No compensation is to be paid out of the commingled account to any of the members of the committee who are affiliated with the bank. Compensation and expenses, if any, may be paid to the members of the committee who are not affiliated with the bank, but the commingled account will be reimbursed by the bank. The agreement provides that the bank will maintain a continuous investment program for the commingled account not inconsistent with its stated investment policy. The bank will determine what securities are to be purchased or sold for the commingled account and will execute transactions for the commingled account accordingly. The agreement further provides that the bank will furnish all custodian, administrative and clerical services, office space, and facilities required for the operation of the commingled account.

The interest of each customer participating in the commingled account is to be reflected in one or more units of participation and all such units shall have equal value. As evidence of the number of units of participation credited to a customer, a receipt will be given for his funds so deposited. Except for periods during which the calculation of net asset value may be suspended as permitted by the rules and regulations of the Securities and Exchange Commission and as detailed in the Plan, a customer will at any

time be able to terminate his participation and cause a calculation of net asset value to be made for purposes of determining the value of the units of participation which are to be terminated and the amount to be withdrawn from the commingled account. In order to protect the rights of participants in the event of a suspension of the payment of terminating distributions, it is provided that if at the time of any such suspension a participant shall have given a notice of termination but shall not yet have received a distribution, such participant shall have the right to withdraw the notice of termination. Termination will occur automatically upon the death of or adjudicated incompetency of the participant. Receipts for units of participation will not as such be transferable by a customer but a participant will be able to transfer his interest in the commingled account only to persons who have the legal capacity to appoint the bank as agent and who sign the broad authorization to the bank to have such funds so invested.

The commingled account will be audited at least semi-annually by independent public accountants selected by the committee and approved by the participants. The financial reports based upon such audits, containing financial statements and other information as required by applicable laws and regulations, shall be filed with the appropriate regulatory authorities and shall be addressed to the committee and to the participants.

For the bank's services, the commingled account will be charged as of the last day of each fiscal quarter a fee payable to the bank based on a percentage of the average of the values of the net assets of the commingled account taken on each valuation date during such quarter for the purpose of determining the asset value of units of participation in the commingled account. The quarterly fee which the bank will receive from the commingled account pursuant to the management agreement will be the only fee charged by the bank in connection with the operation of the commingled account and shall not exceed the fee charged for investment advisory service for individual ac-

counts of less than \$500,000 if assets of the participant had not been invested in participations in the fund. Further, the bank will absorb all costs arising in connection with the organization of the commingled account, which shall include, among other things, costs and expenses attributable to the initial registration and qualification of the commingled account under the federal securities laws; the initial determination of its tax status and any rulings obtained for this purpose; its qualification under the laws of any State; and its approval by the Comptroller of the Currency. The expenses that are charged to the commingled account are brokers' commissions; cost of independent professional services such as legal, auditing or accounting services (other than in connection with the organization of the commingled account), taxes or governmental fees attributable to transactions for the commingled account, or to income from the commingled account assets; costs of maintaining the registration and qualification of the commingled account under the federal securities laws or other applicable regulatory requirements (other than the costs of printing, publication and distribution of current reports to participants, which will be borne by the bank); and the cost of preparation and distribution of notices to participants and proxy statements.

The preceding arrangement is a form of collective investment subject to the requirements of Section 9.18 of Regulation 9. As contemplated, the commingled account does not comply with certain provisions of Section 9.18(b) of the Regulation. However, it appears to us that the arrangement would be a desirable one for the bank and the participating accounts and would embody all of the protections deemed necessary by this Office. Accordingly, pursuant to the provisions of Section 9.18(c)(5) of Regulation 9, the arrangement, and any minor changes within the Plan, letter of authorization and receipt which may be made and which do not detract from the substance of the proposal, is hereby approved so long as the rules and regulations of the Comptroller of the Currency applicable to collective investment, specifically the provisions of Section

9.18(b), except as provided for in the foregoing arrangement, are complied with during the life of the arrangement. In addition, the management contract has the approval of this Office; however, any changes which are made in the contract must be approved by the Comptroller.

Sincerely,

James J. Saxon

JAMES J. SAXON

Comptroller of the Currency

INVESTMENT COMPANY ACT
RELEASE No. 4538

ADMINISTRATIVE PROCEEDINGS
FILE No. 3280

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C.

March 9, 1966

In the Matter of

FIRST NATIONAL CITY BANK
(Commingled Investment Account)
(812-1823)

Investment Company Act of 1940—Section 6(c)

Findings And Opinion of The Commission

No. 80428 thru 804938

EXEMPTIONS

*Composition of Board of Directors of Bank-
Sponsored Collective Investment Fund*

Application by national bank, which proposes to establish and to act as investment adviser of no-load collective investment fund and to register fund as open-end investment company under Investment Company Act of 1940, requesting exemptions pursuant to Section 6(c) of Act from Sections 10(b) (3), 10(c) and 10(d) (2) so as to permit

committee acting as board of directors of fund to include only one member unaffiliated with bank, *granted* as to Sections 10(b) (3) and 10(c) so as to permit majority of Committee members to be affiliated with bank, but *denied* as to Section 10(d) (2) so that requirement that at least 40% of members be unaffiliated with bank will remain in effect.

Custody of Assets

Bonding of Officers and Employees

Where national bank, as sponsor and investment adviser of collective investment fund to be registered under Investment Company Act of 1940, proposes to maintain custody of fund's assets and to continue existing bonding procedures with respect to bank officers and employees having access to those assets, *held*, requested exemptions from Rules 17f-2 and 17g-1 under Act imposing certain requirements with respect to custody and bonding, granted in view of safeguards provided by banking regulations and supervision by banking authorities.

APPEARANCES:

William Everdell III, Stephen Benjamin and Theodore A. Kurz, of Debevoise, Plimpton, Lyons & Gates, for First National City Bank.

Robert L. Augenblick and G. Duane Vieth, James F. Fitzpatrick and Charles R. Halpern, of Arnold & Porter, for Investment Company Institute.

Marc A. White, and Joseph B. Levin, of Brown Lund & Levin, for National Association of Securities Dealers, Inc.

Justice N. Feldman, George J. Solomon and Peyton H. Moss, of Poletti Freidin Prashker Feldman & Gartner, and *John A. Nevius*, for Association of Mutual Fund Plan Sponsors, Inc.

Solomon Freedman, John A. Dudley, Robert E. Olson and William A. Kern, for the Division of Corporate Regulation of the Commission.

First National City Bank ("Bank"), a national banking association, has filed an application pursuant to Section 6(c) of the Investment Company Act of 1940 ("Act") for exemptions from various provisions of and rules under the Act with respect to a Commingled Investment Account ("Account") which the Bank proposes to establish and to register under the Act as a diversified, open-end management investment company.

No evidentiary hearing was requested or ordered by us. Briefs and reply briefs in support of the application were filed by the Bank and by our Division of Corporate Regulation ("Division") which proposed certain conditions, and in opposition to the application by the Investment Company Institute ("ICI"),¹ the National Association of Securities Dealers, Inc. ("NASD"), and the Association of Mutual Fund Plan Sponsors, Inc. ("Sponsors"),² hereinafter referred to as the objectors.³ Statements in opposition were also submitted by the Chairman of the House Committee on Banking and Currency, the Investment Bankers Association of America, and the Association of Stock Exchange Firms, and in support by the Comptroller of the Currency ("Comptroller") and the Federal Deposit Insurance Corporation. Scudder, Stevens & Clark, investment counsel, filed a statement regarding the policy of one of the provisions of the Act involved. We heard oral argument.

THE APPLICATION

It is proposed that the Account be operated as a collective investment fund pursuant to applicable regulations

¹ The ICI is composed of 159 registered, open-end management investment companies and also of underwriters and investment advisers to those companies.

² Sponsors has as its members some 20 sponsor companies of contractual plans for the accumulation of interests in mutual funds.

³ In granting leave to the objectors to file briefs and present oral argument, we stated that we were not passing on the question, raised by the Bank, as to their standing to participate.

of the Comptroller and accept investments of \$10,000 or more pursuant to agreements between investors ("participants") and the Bank. The funds in the Account will be represented by units of participation of equal value, and each participant will be entitled to one vote for each unit held.

Following registration of the Account as an investment company, the initial capital of \$100,000 required by Section 14(a) of the Act will be obtained through a private offering, and additional participations will be offered pursuant to a registration statement under the Securities Act of 1933.⁴ No broker or dealer will be engaged to underwrite or distribute the participations, and no sales load or redemption charges will be imposed.⁵ Funds in the Account will be invested principally in common stocks and securities convertible into common stocks. The operation of the Account will be subject to the supervision of a committee of at least three persons ("Committee"). The initial Committee, which according to the Bank's brief will consist of seven persons, will be appointed by the Bank and thereafter the members of the Committee will be elected annually by the participants. At least one member of the Committee will be a person who is not affiliated with the Bank, and it is proposed in the Bank's brief that six of the initial members will be officers in the Bank's Trust and Investment Division. Under a proposed management agreement, subject to approval of the participants at their first annual meeting, the Bank will serve as investment adviser and custodian for the Account, will determine what securities

⁴ Under Section 2(a) (8) of the Act, a "fund," such as the Account, is an investment company. Section 3(a) (2) of the Securities Act of 1933 exempts from that Act any security issued by a national bank. However, this exemption refers to an interest in or obligation of the bank, and would not apply to the participations in the Account.

⁵ It is assumed that the Bank will enter into an arrangement with the account for the sale of participations in the Account. See Section 15(b) of the Act.

are to be purchased and sold, and will execute all transactions. It will furnish all administrative and clerical services, office space and other facilities, and will pay all organization costs and expenses. For its services, the Bank will receive a fee equal, on an annual basis, to $\frac{1}{2}$ of 1% of the average net asset value of the Account.

BACKGROUND

The Bank has for many years offered to customers an investment advisory service whereby it undertakes to hold and manage for the customer in a so-called managing agency account a portfolio of investments pursuant to a power of attorney giving the Bank complete investment discretion. However, the smallest managing agency account which the Bank considers it can economically accept is about \$200,000, and the Bank states that the purpose of the Account is to make available similar managing services to smaller investors. Prior to 1963, national banks, while authorized to commingle and invest trust funds held as trustee, executor, administrator or guardian,^{5a} were not permitted to commingle managing agency accounts. In that year, the Comptroller revised Regulation 9 (12 CFR 9), which governs the exercise by national banks of their fiduciary functions,⁶ so as to permit the collective investment by a national bank of funds received in managing agency accounts as a fiduciary if approved by the Comptroller in writing. (12 CFR 9.18(c) (5)). Pursuant to that provision, the Comptroller has approved the arrangement proposed by the Bank, and the Board of Governors of the Federal Reserve System has ruled that such arrangement would not violate Section 32 of the Banking Act of 1933, which prohibits any individual primarily engaged in, or

^{5a} Common trust funds are exempt from the Act. Section 3(c) (3).

⁶ In 1962 the authority to permit national banks to act as trustees and in other fiduciary capacities and to regulate their exercise of such powers was transferred from the Board of Governors of the Federal Reserve System to the Comptroller. Publ. L. 87-722, 76 Stat. 668 (September 28, 1962).

associated with a corporation or partnership primarily engaged in, the "issue, flotation, underwriting, public sale, or distribution . . . of . . . securities" from serving as an officer, director or employee of any member bank of the Federal Reserve System.⁷

Thus, the Federal Reserve Board, which has primary responsibility for passing upon questions under Section 32, has ruled that the proposed arrangement would not violate that Section, the Comptroller has approved the arrangement in writing pursuant to revised Regulation 9, and as mentioned above, the Federal Deposit Insurance Corporation as well as the Comptroller support the application. With all three bank regulatory agencies, either expressly or by necessary implication, regarding the arrangement as consistent with the statutes they administer, we do not deem it necessary to consider further the questions that have been raised as to the legality of the proposed arrangement under Section 32 as well as Section 21⁸ of the Banking Act by the Chairman of the House Banking and Currency Committee and some of the objectors.⁹ With respect to Section 21, the office of the Attorney General of the United States, in response to an inquiry by the Committee Chairman, has indicated that it is not clear whether the proposal would involve criminal liability under that Section and that since banking agencies have approved the proposal, a prosecution against the Bank at this time could

⁷ 12 CFR 218.111.

⁸ Section 21 of the Banking Act prohibits any person, firm, association, business trust or other similar organization "engaged in the business of issuing, underwriting, selling or distributing" securities from engaging at the same time "in the business of receiving deposits," and provides criminal penalties for willful violations. Under 12 U.S.C. § 24 national banks may purchase and sell securities upon the order and for the account of customers.

⁹ Cf. *The Prudential Insurance Company of America*, Investment Company Act Release No. 3620 (January 22, 1963), *aff'd* 326 F.2d 383 (C.A. 3, 1964), *cert. denied* 377 U.S. 953; *Midland Enterprises, Inc.*, 40 S.E.C. 818, 821 (1961).

not be successfully conducted. We accordingly proceed to a consideration of the requested exemptions on the assumption that the proposal does not violate the banking laws.

EXEMPTIONS SOUGHT

The principal exemptions sought for the Account, and the only ones which are contested, are those from Sections 10(b) (3), 10(c) and 10(d) (2) of the Act,¹⁰ in order to permit all but one of the members of the Committee, which is the statutory equivalent of a board of directors,¹¹ to be affiliated with the Bank. Additional exemptions are requested from Rules 17 CFR 270.17f-2 and 17g-1 under Sections 17(f) and 17(g), and temporary exemptions, until the first annual meeting of participants, from Sections 15(a), 16(a) and 32(a) (2). We discuss first the requested exemption from Section 10(c).

¹⁰Section 10(b)(3) provides that a registered investment company may not have a person affiliated with an investment banker as a director unless a majority of the board is not so affiliated.

Under Section 10(c), a majority of the board of a registered investment company may not consist of persons who are officers or directors of any one bank. Section 10(d) provides that, notwithstanding the requirement of Section 10(a) that no more than 60% of the board members of a registered investment company be affiliated with the investment adviser, companies charging no sales load and meeting other specified conditions, including the conditions in Section 10(d) (2) that the investment adviser be registered under the Investment Advisers Act of 1940 and be engaged principally in the business of rendering investment supervisory services as defined in that Act, need have only one such unaffiliated director.

¹¹Section 2(a) (12) of the Act in pertinent part defines the term "director" to mean "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated."

The NASD contends that the true directors of the Account will be the directors of the Bank rather than the members of the Committee, and argues that the participants will therefore be denied the right to elect the directors of the Account as required by Sections 16(a) and 18(i) of the Act. However, it is assumed that the Committee or its members will discharge their responsibilities as directors, or persons performing similar functions, under the securities acts or otherwise.

1. *Section 10(c)*

Under Section 10(c), a majority of the Committee may not consist of persons who are officers or directors of the Bank. The objectors, in addition to urging a limited scope for our exemptive power under Section 6(c),¹² contend that Section 10(c) reflects a policy of prohibiting the domination of mutual funds by banks with its inherent potentialities for conflicts of interest and was intended to apply to all types of investment companies. They further contend that the asserted protections to investors resulting from the Bank's fiduciary position and from banking regulations and supervision are inadequate substitutes for the protections of Section 10.

We have held that the propriety of granting an exemption pursuant to Section 6(c) of the Act "largely depends upon the purposes of the section from which an exemption is requested, the evils against which it is directed, and the end which it seeks to accomplish."¹³ Section 6(c) was put into the Act for the purpose, among others, of permitting the exemption of persons "who are not within the intent of the proposed legislation . . ." [citing Sen. Rep. No. 1775 (76th Cong., 3rd Sess.) at p. 13] even though such persons come within the scope of the Act by virtue of its specific provisions . . . This was to take care of special situations that might have been overlooked or that could not be foreseen at the time the legislation was drafted."¹⁴ In such

¹² Section 6(c) of the Act provides in pertinent part that we may exempt any person from any provision of the Act "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act.

¹³ *Transit Investment Corporation*, 28 S.E.C. 10, 16 (1948). See also *American Participations, Inc.*, 10 S.E.C. 431 (1941) and cases cited in n. 17 of the *Transit Investment* case.

¹⁴ *The Atlantic Coast Line Company*, 11 S.E.C. 61, 666-667 (1942). See also *The Variable Annuity Life Insurance Company of America*, 39 S.E.C. 680, 685 (1960).

situations the showing required in order to meet the public interest and related standards set forth in Section 6(c) is that the compliance from which exemption is sought is not necessary to accomplish the Act's objectives and policies.¹⁵ The fact that Congress adopted in Section 10(c) a specific prohibition against bank domination of an investment company does not preclude an exemption from that section pursuant to Section 6(c). In *Transit Investment Corporation*,¹⁶ we held that the "purposes fairly intended by the policy and provisions" of the Act obviously means something more than a literal reading only of the provision from which an exception is desired. Otherwise, the existence of a provision prohibiting a transaction, which in every case under Section 6(c) is the very reason why an application for exemption is necessary, would also be the very reason for denying the application, thus making it impossible to resort to Section 6(c) to exempt a transaction from any provision of the Act."

Although Section 10(c) is general in terms, it does not appear that it was directed at the type of open-end investment company represented by the Account. We have already pointed out that it was not until 1963 that a commingled account such as the Bank proposes to establish became possible. Moreover, as stressed by the Bank, it is clear that the Account is substantially different, both in purpose and nature of operation, from the bank-dominated investment companies described in this Commission's Report to Congress on Investment Trusts and Investment Companies, which led to the passage of the Act, and in the testimony at the Congressional hearings. As detailed in that Report,¹⁷ the legal restrictions on the power of com-

¹⁵ *The Prudential Insurance Company of America*, Investment Company Act Release No. 3620 (January 22, 1963), p. 8.

¹⁶ 28 S.E.C. 10, 17, n. 20 (1948).

¹⁷ See Report on Investment Trusts and Investment Companies, Part I, pp. 93-95 (1939).

mercial banks to engage in investment banking activities gave rise to the development, particularly during the 1920's, of securities affiliates designed to enable banks to participate indirectly in such activities and thereby avoid those restrictions. Those affiliates, whose securities were usually sold or issued as stock dividends to the bank's shareholders, frequently took the form of closed-end investment companies, or the affiliates sponsored such companies. Part III of our Report, dealing with abuses and deficiencies in the organization and operation of investment trusts and investment companies, recited in detail the history of two bank-affiliated investment companies.¹⁸ Flagrant instances of self-dealing to the injury of those companies were revealed, including loans by the investment company to the securities affiliate to enable the latter to pay for a controlling interest in the investment company, use of investment company funds to trade in the bank's stock, and investment of such funds in the bank's stock or in other securities in which the sponsors were interested.¹⁹

Recently, former Chairman Cary of this Commission, in testifying before a subcommittee of the House Committee on Government Operations on the desirability of registration and regulation under the Act of bank-sponsored collective investment funds, referred to areas of potential conflicts of interest, including the deposit of the fund's cash in the bank, the placement of the fund's brokerage business, the use of fund investments to "shore up" bank investments, and the acquisition by the fund of securities underwritten by the bank.²⁰

¹⁸ See pp. 115-181.

¹⁹ See also Hearings on S. 3580 before a Subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3rd Sess., pp. 207-9, 793-4 (1940) ("Senate Hearings").

²⁰ Hearings on Common Trust Funds—Overlapping Responsibility and Conflict in Regulation, 88th Cong., 1st Sess., pp. 11-12 (1963).

In our opinion, the Bank has shown that substantial safeguards are present here against conflicts of interest which could arise as a result of the Bank's commercial banking activities. The Account, unlike the bank-sponsored investment companies with which Congress was concerned in enacting Section 10(c), is regarded by the banking authorities as one aspect of the Bank's fiduciary functions and as such will be subject to the supervision and regulation of those authorities. While banking oversight is of course not the same in scope or orientation as the protective provisions of the Act, it will provide participants in the Account with additional protections not afforded investors in other investment companies.²¹ Among other things, the Comptroller's office, as part of its periodic examination of national banks,²² examines the investments held by the Bank as fiduciary to determine whether such investments are in accordance with law, Regulation 9 and sound fiduciary principles.²³ And, as stressed by the Bank, while the funds of the participants will not be received by the Bank as trustee, the Bank will act as managing agent and as such will be subject to fiduciary responsibilities.²⁴

With respect to the areas of potential conflicts of interest cited by Chairman Cary, to leave funds uninvested would,

²¹ Of course, important protections and restrictions in the Act itself with respect to transactions between an investment company and its adviser or other affiliated persons, providing safeguards against conflicts of interest, would remain applicable here. For example, Section 12(d) (3) and Rule 17 CFB 270.2a-3 would prohibit the Account from purchasing any securities issued by the Bank, Section 17(a) would prohibit the Bank or its affiliated persons from selling any securities to the Account or borrowing money from it, and Section 17(d), as implemented by Rule 17 CFB 270.17d-1, would prohibit the Account and the Bank from participating in any joint enterprise or other joint arrangement without our prior approval.

²² Such banks must be examined at least three times in every two years. 12 U.S.C. § 481.

²³ 12 CFB 9.11(d).

²⁴ See *Restatement (Second), Agency* § 13, comment a and § 425, comment a (1958).

as pointed out by the Bank, be contrary to the stated policy of the Account to make investments for long-term growth of capital and income and its own interest in having the Account's value increase, and any attempt by the Bank to use the Account's cash to increase the Bank's deposits would violate the Comptroller's regulations.²⁵ With respect to brokerage allocation, the Account's prospectuses will represent that the Bank's primary objective in placing orders for portfolio transactions for the Account will be to obtain the most favorable prices, and that it is the Bank's practice to place such orders with brokers and dealers who supply it with supplementary research and statistical information or market quotations. Any use of Account investments to "shore up" Bank loans is forbidden by a regulation of the Comptroller which prohibits purchases of securities from and of organizations "in which there exists such an interest, as might affect the exercise of the best judgment of the bank" in acquiring them.²⁶ Moreover, we will have continuing oversight over any transactions involving a joint arrangement between the Bank and the Account within the meaning of Section 17(d) of the Act and Rule 17d-1 thereunder. The remaining area of potential conflict cited by Chairman Cary, involving possible acquisition by the Account of securities underwritten by the Bank, is more closely related to the requested exemption from Section 10(b) (3) discussed below.

In determining whether the requested exemption from Section 10(c) should be granted we have also taken into

²⁵ Section 9.10(a) of Regulation 9 states that funds "held in a fiduciary capacity by a national bank awaiting investment or distribution shall not be held uninvested or undistributed any longer than is reasonable for the proper management of the account." The Comptroller's Representatives in Trust, who regularly examine the operations of national bank trust departments, are instructed that "it is a breach of trust for the bank negligently or otherwise improperly to withhold investment or distribution." Comptroller's Manual for Representatives in Trust 80 (1965).

²⁶ 12 CFR 9.12(a).

account the fact that Congress contemplated some relationships between banks and investment funds, including some which are quite similar to those involved under the proposed arrangement. For example, a common trust fund or similar fund maintained by a bank for the collective investment of moneys contributed thereto by the bank in its capacity as trustee, executor, administrator or guardian is expressly excluded from the definition of an investment company by Section 3(c) (3) of the Act, thus indicating that such funds, which are quite similar to the Account insofar as the policies of the banking laws are concerned, might otherwise fall within the definition of an investment company. In addition, Section 10(c) of the Act expressly permits a minority of the board of directors of a registered investment company to be officers and directors of a bank and nothing in the Act prohibits a bank from acting as investment adviser to an investment company, and a few investment companies registered with us do have banks as their advisers. Under all the circumstances, including the existence of the provisions designed to provide safeguards against conflicts of interest, we conclude that it is appropriate to exercise our exemptive power under Section 6(c) to grant the exemption.

2. Section 10(b) (3)

We also find that it is appropriate to exempt the Account from Section 10 (b) (3), subject to one condition set forth below. Under that Section, the Committee may not have a member who is affiliated with an investment banker unless a majority of the Committee is not so affiliated. The Bank states that it might be deemed to be an "investment banker," defined by Section 2(a) (20) of the Act as any person engaged in the business of underwriting securities issued by other persons, since it participates from time to time in syndicates underwriting United States Government and municipal obligations.

The legislative history of the Act, particularly this Commission's Report and the Congressional hearings,²⁷ reflects instances where an investment banker used an affiliated investment company to promote its investment banking business to the detriment of investors in the investment company. For example, securities underwritten or held by the banker were transferred to the investment company, and the investment company was caused to make investments which gave the banker access to the investment banking business of the company whose securities were purchased.²⁸ It was this type of abuse that Section 10(b) (3) was directed against. We do not think there is any basis for concern that the Bank, *qua* investment banker, can or will use the Account to its advantage, particularly since the Account is primarily a stock fund and the Bank is limited to underwriting debt securities of governmental authorities.

Section 17(a) of the Act itself, as previously noted, would prohibit sales of securities by the Bank to the Account and Section 10(f) would prohibit the Account, with one limited exception if the conditions in Rule 17 CFR 10f-3 are met, from purchasing or otherwise acquiring, during the existence of any underwriting syndicate, any security for which the Bank is acting as a principal underwriter. In addition, the Bank has stated that it is agreeable to a condition, which we shall impose, extending the duration of the prohibitions of Section 10(f) under circumstances where a syndicate has been terminated while its members still have unsold allotments. Moreover, the additional safeguards provided by bank regulation and fiduciary principles discussed in connection with Section 10(c) are equally applicable here.

²⁷ S.E.C. Report, Part I, pp. 76-83; Senate Hearings pp. 207, 209-214, 222-3, 887.

²⁸ See House Hearings, p. 110.

3. Section 10(d)(2)

Section 10(d) provides that, notwithstanding Section 10(a), which would limit the number of members of the Committee affiliated with the Bank to 60%, an investment company charging no sales load and meeting other specified conditions need have only one director who is not affiliated with its investment adviser. The Account would meet all such conditions except those in Section 10(d)(2) that the investment adviser be registered under the Investment Advisers Act of 1940 ("Adviser Act") and be "engaged principally in the business of rendering investment supervisory services" as defined in that Act.²⁹ The Bank states that while such services are an important aspect of its business, it may not be "engaged principally" in such business; and, by definition, a bank is not an investment adviser under the Advisers Act.³⁰ The Bank argues that the Account is similar to no-load mutual funds sponsored by investment advisers for which Section 10(d) was designed.

We are not persuaded on the basis of the submissions before us that an exemption from Section 10(d)(2) is necessary to enable the Bank to create and operate the Account under the rulings of the banking authorities or is otherwise necessary or appropriate in the public interest. The approval of the Bank's proposal by the Comptroller and the Federal Reserve Board does not appear to preclude more than one unaffiliated member on the Committee, provided, as stated by the Board, the Account will "be operated under the effective control of the bank."³¹ We shall accordingly deny the requested exemption from

²⁹ Section 202(a) (13) of the Advisers Act defines "investment supervisory services" as the "giving of continuous advice as to the investment of funds on the basis of the individual needs of each client."

³⁰ Section 202 (a) (11).

³¹ 12 CFR 218.111.

Section 10(d)(2). In view of our conclusion we do not address ourselves to the conditions which the Division suggested we impose in the event we granted such an exemption.

4. Other Requested Exemptions

Section 17(f) of the Act provides that a registered management investment company may maintain its securities in the custody of a bank meeting certain requirements as to capital, surplus and undivided profits, or in its own custody in accordance with rules prescribed by us. Rule 17f-2 prescribes the conditions under which the company may maintain custody. The Bank's application states that under the proposed management agreement, the securities and other assets of the Account will be placed in the custody of the bank, which meets the specified capital and other requirements, but that it might be contended that the Account was itself maintaining custody and that such custody must comply with the provisions of the Rule. An exemption is therefore requested from Rule 17f-2 so long as the securities and other assets of the Account are maintained in the custody of the Bank.

Rule 17g-1 requires that any officer or employee of a registered management investment company who may have access to securities or funds of such company, be bonded, prescribes the manner in which the amount of the bond is to be determined, and provides for certain filings and notices. The Bank's application states that although Rule 17g-1 may be inapplicable, because the Account will have no officers or employees, the Rule might be deemed applicable to the Bank's officers and employees having access to the Account's securities or funds. Accordingly the Bank requests an exemption from the Rule.

The Bank urges that the participants will be adequately protected without requiring its compliance with Rules 17f-2

and 17g-1. It states that it will maintain custody of the Account's investments in the same manner in which custody of investments is maintained for other fiduciary accounts of the Bank, that its officers and employees will be adequately bonded, and that its procedures and practices in these respects are subject to regulation and supervision by governmental authorities having supervision over banks. It appears that under the circumstances adequate safeguards will be afforded with respect to the custody of the Account's securities and the bonding of persons who may have access to such securities or to the Account's funds, and we find that it is appropriate to grant the exemptions requested.²²

We also find that it is appropriate to grant the requested temporary exemptions from Sections 15(a), 16(a) and 32(a)(2). Section 15(a) requires initial shareholder approval of the investment advisory contract. Sections 16(a) and 32(a)(2) require, respectively, that directors of an investment company be elected by its shareholders and that the selection of an auditor be ratified by such shareholders. We have ordinarily granted temporary exemptions from these provisions to enable newly-formed investment companies to operate until the first annual shareholders meeting.

An appropriate order will issue.

By the Commission (Chairman COHEN and Commissioners WOODSIDE, OWENS and WHEAT), Commissioner BUDGE dissenting.

ORVAL L. DuBOIS
Secretary.

Commissioner BUDGE, dissenting:

The granting of the requested exemptions is contrary to the clearly expressed policy of the Congress against bank

²² Cf. *The Prudential Insurance Company of America, supra*, at p. 20 of cited Release.

domination of investment companies. Section 10(c) of the Investment Company Act of 1940 specifically provides that "... no registered investment company shall have a majority of its board of directors consisting of persons who are officers or directors of any one bank. . . ." The Bank in order to register its Account seeks to be exempted from that provision as well as others. Such exemption may not be granted under the authority of Section 6(c) until and after a finding is made that it is "necessary or appropriate in the public interest" and "consistent with the protection of investors" and that it is consistent with "the purposes fairly intended by the policy and provisions" of the Act. The language of Section 10(c) is unambiguous, and as the Commission has correctly emphasized on several occasions, the exemptive power under Section 6(c) must not be exercised to thwart the stated objectives of the Act.¹

While it may well be that entry of the banking industry in the mutual fund business would be a healthy addition—a view not shared by the bank regulatory agencies until just recently—nevertheless, the banks should not enter until after they have met the conditions prescribed by the Congress. Because of the demonstrated conflicts as well as the potential conflicts of interest between a bank and an investment company it dominates, good reason existed in 1940 for the Congress to impose the restrictions of Section 10(c).² There is no showing in this proceeding

¹ *The Variable Annuity Life Insurance Company of America*, 39 S.E.C. 680, 685 (1960); *Petroleum and Trading Corporation*, 11 S.E.C. 389, 392 (1942); *American Participations, Inc.* 10 S.E.C. 430 437 n. 8 (1941).

² The chief counsel for the Commission's Investment Trust Study testified at the Congressional hearings that "there were very undesirable consequences flowing from interlocking directorships or interlocking relationships between commercial banks and investment companies. Some of the worst examples of abuses we had in the whole study arose out of that relationship and the Federal Reserve Board as well as ourselves, felt that in the future there should not be that close relationship." Hearings on H. R. 10065 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 76th Congress, 3d Sess., pp. 110-111 (1940).

that those conflicts do not exist today, nor can the exact form of future conflicts be anticipated. If the specific prohibition of the Congress in this broad policy area is to be avoided, it should be done by the Congress and not through the granting of ad hoc exemptions by the Commission.

Congressional action is particularly appropriate when, as here, there are contrary interpretations between federal agencies as to the very nature of the entity being created. On the one hand the Commission in considering this application finds the bank to be one creature and the proposed investment company to be a separate creature in order that they may be capable of bargaining and contracting with one another. On the other hand, the federal agencies administering the banking statutes have adopted a "single entity" theory, finding the investment company to be "nothing more than an arm or department" of the Bank.³

The "single entity" interpretation is a realistic appraisal of the true nature of the Bank's proposed operation.⁴ We then have the strange result that even though the Investment Company Act prohibits bank officers or directors from constituting a majority of the board of an investment company, yet this proposed "investment company" will in fact be part and parcel and will "be operated under the effective control of the Bank."⁵ The lack of any real

³ Federal Reserve Board interpretation at 30 Fed. Reg. 12836, 12837 (1965) adding 12 C.F.R. §218.111 and memorandum "Legal Considerations under Section 32 of the Banking Act of 1933 in Connection with the Proposed 'Commingled Investment Account' of First National City Bank of New York," Federal Reserve Board, p. 24, December 15, 1965. The Comptroller of the Currency holds and has repeatedly urged the same single entity theory.

⁴ The single entity theory is the premise on which the conclusion was reached that the Bank proposal was not violative of the banking statutes. See Footnote 3. If the conclusion is adopted, it should embrace the premise.

⁵ Federal Reserve Board interpretation at 30 Fed. Reg. 12836 (1965) adding 12 C.F.R. 218.111

separation between the interests of investors in this "investment company" and the interests of the Bank is apparent. It was to protect investors against such interlocks and resultant conflicts of interest that the prohibition in Section 10(c) was aimed.⁶ The protection of the 1940 Act vanish when the entities become one.

On the record here I am unable to conclude that it is "necessary or appropriate in the public interest" and "consistent with the protection of investors" and consistent with "the purposes fairly intended by the policy and provisions of the Act" to grant the exemptions herein sought. For that reason, I would deny the application.

⁶ The objective of Section 10(c) is consistent with one of the aims of the Banking Act of 1933; ie, to eliminate abuses arising from conflicts of interest by separating most aspects of the banking business from the securities business. Section 21 of that Act (12 U.S.C. §378) prohibits firms engaged in the business of issuing, underwriting, selling, or distributing securities from engaging at the same time "to any extent whatever" in the business of receiving deposits.

Section 16 of the Banking Act of 1933 provides that a bank "shall not underwrite any issue of securities." 12 U.S.C. §24. The banking laws specifically permit banks to underwrite only a limited group of debt securities of governmental authorities. 12 U.S.C. §24.

Sections 20 and 32 (12 U.S.C. §377 and 12 U.S.C. §78) of the banking Act of 1933 were designed to separate banks from their security affiliates and to prevent interlocking relationships between bank officials or employees and security firms. The Supreme Court in *Federal Reserve System v. Agnew*, 329 U.S. 441, 449 (1947) has stated that Section 32 was designed "to remove tempting opportunities from the management and personnel of member banks." The Federal Reserve Board in its interpretations of the latter Section has prohibited all bank personnel from serving as directors of investment companies continuously offering their securities. See e.g., 46 Fed. Res. Bull. 371 (1960), 37 Fed. Res. Bull. 645 (1951), and 27 Fed. Res. Bull. 399 (1941).

**Order Granting in Part And Denying in Part
Applications For Exemptions**

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

March 9, 1966

In the Matter of

FIRST NATIONAL CITY BANK
(Commingled Investment Account)
(812-1823)

Investment Company Act of 1940—Section 6(c)

First National City Bank ("Bank") having filed an application pursuant to Section 6(c) of the Investment Company Act of 1940 ("Act") for exemptions from various provisions of and rules under the Act with respect to a Commingled Investment Account ("Account") which the Bank proposes to establish and to register under the Act as a diversified, open-end management investment company;

Briefs and statements having been filed, and the Commission having heard oral argument;

The Commission having this day issued its Findings and Opinion; on the basis of said Findings and Opinion

IT IS ORDERED that exemptions from Sections 10(b)(3) and 10(c), from Rules 17 CFR 270.17f-2 and 17g-1 so long as the securities and other assets of the Account are maintained in the custody of the Bank, and from Sections 15(a), 16(a) and 32(a)(2) until the first annual meeting of investors in the Account, be, and they hereby are, granted subject, however, to the condition with respect to Section 10(b)(3) that the prohibitions in Section 10(f) of the Act against purchases by the Account, during the existence of any underwriting or selling syndicate, of securities of

which the Bank is a principal underwriter be extended to include the period after a syndicate has been terminated and while its members still have unsold allotments.

It Is FURTHER ORDERED that an exemption from Section 10(d)(2) be, and it hereby is, denied.

By the Commission.

ORVAL L. DuBOIS
Secretary

Correction of Findings, Opinion and Order

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C.

March 14, 1966

In the Matter of

FIRST NATIONAL CITY BANK

(Commingled Investment Account)
(812-1823)

Investment Company Act of 1940—Section 6(c)

The Commission's Findings, Opinion and Order in this matter issued March 9, 1966 (Release No. 4538) is hereby amended as follows:

1. Change footnote 5, p. 3 to read as follows:

⁵ It is assumed that the arrangement for providing participations in the Account will be reflected in a written agreement between the Bank and the Account which will

contain the protective provisions specified in Section 15(b) of the Act. As indicated in this opinion the banking authorities view the Account as an integral part of the Bank's authorized banking functions, and regard the Bank merely as acting as managing agent for its customers. We assume therefore that the banking authorities do not deem the proposal before us to be precluded by the provisions of the banking laws. The statutory scheme and specific purpose of the securities acts, on the other hand, require that we regard the Bank as a statutory underwriter, and the provisions contained in the Investment Company Act with respect to relationships and transactions between a principal underwriter and a registered investment company are applicable. However, for the reasons set forth in this opinion in granting certain of the exemptions requested and in view of the no-load character of the Account, we do not consider that conformance with the provisions of Section 10(b)(2), which in effect prohibit a majority of the directors of a registered investment company from being affiliated persons of its principal underwriter, is necessary or appropriate here. Accordingly, and since the Bank's application includes a request for an exemption from Section 10(d)(2) which would, if granted, embody an exemption from Section 10(b)(2), we shall grant an exemption from the latter section as partial relief.

2. In the Order, insert "10(b)(2)" after the word "Sections" in the first line of the fourth paragraph.

By the Commission.

ORVAL L. DuBOIS
Secretary

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

In the Matter of
FIRST NATIONAL CITY BANK
(Commingled Investment Account)
399 Park Avenue
New York, New York 10022
(812-1823)
(Investment Company Act of 1940)

Petition for Rehearing

In its Findings and Opinion of March 9, 1966, Investment Company Act Release No. 4538, The Commission made the following statements:

"The NASD contends that the true directors of the Account will be the directors of the Bank rather than the members of the Committee, and argues that the participants will therefore be denied the right to elect the directors of the Account as required by Sections 16(a) and 18(i) of the Act. However, it is assumed that the Committee or its members will discharge their responsibilities as directors, or persons performing similar functions, under the securities acts or otherwise." (p. 5, note 11)

"We are not persuaded on the basis of the submissions before us that an exemption from Section 10(d)(2) is necessary to enable the Bank to create and operate the Account under the rulings of the banking authorities or is otherwise necessary or appropriate in the public interest. The approval of the Bank's proposal by the Comptroller and the Federal Reserve Board does not appear to preclude more than one unaffiliated member on the Committee, provided, as stated by the

Board, the Account will 'be operated under the effective control of the bank.'" (p. 10)

1. The Commission may not find that it is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title"* and grant exemptions from Sections 10(c) and 10(b)(3) of the Investment Company Act of 1940 ("the Act") relating to the composition of a board of directors, unless the Commission is satisfied that the board will be vested with the directorial duties and functions contemplated by the statute. The Commission may not avoid this matter, by "assuming" compliance, particularly in the face of the record before it. (See following briefs of the National Association of Securities Dealers, Inc.: main brief, pp. 6-16; reply brief, pp. 13-19; and brief and reply brief in support of motion for amendment.)

2. Furthermore, the Commission, even by way of assumption, has not stated that there will be compliance with the Act. The discharge of directorial responsibilities assumed by the Commission is "under the securities acts or otherwise." (Emphasis added.) Thus, the Commission is saying that the directorial performance may not necessarily satisfy the requirements of the Act, but rather some amorphous and unidentified "otherwise".

3. Moreover, by proceeding on the hypothesis that the "account will 'be operated under the effective control of the bank'", the Commission has acknowledged the validity of our contention that the directors of the First National City Bank, and not the Committee, will have the ultimate responsibility for the management and direction of the Account.

* Section 6(c) of the Investment Company Act of 1940.

The Commission should reconsider its conclusions and deny the exemptions granted from Sections 10(c) and 10(b)(3) of the Act.

Respectfully submitted,

MARC A. WHITE
General Counsel
National Association of Securities Dealers, Inc.
888 17th Street, N.W.
Washington, D.C. 20006

JOSEPH B. LEVIN
BROWN LUND & LEVIN
1625 Eye Street, N.W.
Washington, D.C. 20006
Of Counsel

March 14, 1966

Order Denying Petition For Rehearing

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

April 6, 1966

In the Matter of

FIRST NATIONAL CITY BANK

(Commingled Investment Account)
(812-1823)

Investment Company Act of 1940—Section 6(c)

The National Association of Securities Dealers, Inc., one of the objectors in proceedings on an application of First National City Bank ("Bank") pursuant to Section 6(c) of the Investment Company Act of 1940 ("Act"), filed a petition for rehearing with respect to the Commission's Find-

ings, Opinion and Order of March 9, 1966 (Investment Company Act Release No. 4538). In that decision, the Commission granted exemptions from Sections 10(c) and 10(b)(3) and denied an exemption from Section 10(d)(2) of the Act with respect to the composition of a Committee which would be charged with supervision of a Commingled Investment Account ("Account") proposed to be established by the Bank and registered as an open-end investment company.

Petitioner, in urging the Commission to reconsider its decision, asserted that the Commission could not grant the cited exemptions unless it was satisfied that the Committee would be vested with the directorial responsibilities contemplated by the Act. Petitioner contended that the Commission merely "assumed" that the Committee would discharge its responsibilities "under the securities acts or otherwise." In addition, petitioner asserted that the last quoted phrase, by its use of the disjunctive, indicated that the Committee's directorial performance need not satisfy the requirements of the securities acts. Finally, petitioner asserted that the Commission's decision recognized that the directors of the Bank, which will act as investment adviser to the Account, will have the ultimate responsibility for its management and direction and that the investors in the Account, who will vote only for the members of the Committee, will therefore be denied the right to elect the true directors of the Account as required by Sections 16(a) and 18(i) of the Act. This assertion was based on the Commission's finding, in connection with its refusal to grant an exemption from Section 10(d)(2) which would have permitted only one member of the Committee to be unaffiliated with the Bank, that the approval of the Bank's proposal by the banking authorities did not appear to preclude more than one unaffiliated member provided, as stated by the Federal Reserve Board, the Account will "be operated under the effective control of the bank."

The Commission was of the opinion that the contentions of petitioner, which were in substance the same as or based upon arguments previously presented, were without merit. It saw no inconsistency between the Federal Reserve Board's view that the Account was an arm or department of the Bank for purposes of the Banking Act of 1933 and under the effective control of the Bank, and its own view that for purposes of the Investment Company Act the account was a separate entity whose Committee was subject to its applicable provisions of that Act. Indeed, the Federal Reserve Board in its decision recognized that the Account would have to comply with certain requirements of the securities laws not applicable to a common trust fund operated by a bank, and particularly that "supervision" of the Account would be "in the hands of a committee" elected by the investors. In assuming that the Committee, at least 40% of whose members must be unaffiliated with the Bank, would discharge its responsibilities under the "securities acts or otherwise," the Commission clearly indicated that in its opinion the banking laws or regulations did not preclude the exercise of such responsibilities. Moreover, the Commission pointed out that its use of the disjunctive was obviously not intended to imply that the Committee was free to avoid discharging any of the responsibilities which attach to it under the securities acts.

Accordingly, It Is ORDERED that the petition for rehearing be, and it hereby is, denied.

By the Commission.

ORVAL L. DuBOIS
Secretary

IN THE
UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 20,164

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent,*
FIRST NATIONAL CITY BANK, *Intervenor.*

Prehearing Conference Stipulation

Pursuant to Rule 38(k) of this Court, and subject to its approval, the parties and First National City Bank, intervenor herein, hereby stipulate and agree as follows with respect to the issues and the contents of the joint appendix herein.

I.

Issues

Counsel for the parties and the intervenor exchanged proposed statements of issues and met in an attempt to agree upon a joint statement of issues. They were unable to do so. In the light of the discussion among counsel, counsel for the parties and the intervenor understand the nature of the contentions to be made by each other, and will be able to proceed with the preparation of the case.

Counsel for the petitioner tentatively state their view of the issues as follows:

1. Whether the Commission exceeded its authority under Section 6(c) of the Investment Company Act in granting exemptions from Section 10 of that Act.
2. Whether the granted exemptions are consistent with the purposes fairly intended by the policy and provisions of the Investment Company Act and the protection of

investors, and are necessary or appropriate in the public interest.

3. Whether the Commission may grant exemptions from Section 10 of the Investment Company Act unless it finds that the Committee here proposed will exercise the directorial functions contemplated by the Act, without which exercise investors would in effect be denied the companion statutory rights to vote and elect directors.

4. Whether the Commission failed to comply with Section 8(b) of the Administrative Procedure Act.

Counsel for respondent and counsel for the intervenor tentatively state their view of the issues as follows:

1. Whether the Commission acted within the bounds of its discretionary authority under Section 6(c) of the Investment Company Act of 1940 in exempting a bank collective investment fund from certain provisions of Section 10 of that Act, which, in effect, would have required a majority of the board of directors of the fund to be composed of persons who are not officers or directors of the bank, with the result that at least 40 per cent of the board members will at all times be persons "unaffiliated" with the bank.

2. Whether the Commission was entitled to assume that the provisions of the Investment Company Act of 1940 would be complied with by the directors of the bank collective investment fund, in the absence of any showing to the contrary.

Counsel for the intervenor tentatively states the following additional issue:

Whether the Court should dismiss a petition for review of Orders of the Securities and Exchange Commission permitting registration under the Investment Company Act of 1940 of a bank collective investment fund which charges no sales load where petitioner is an association of brokers and dealers who have made no showing of injury result-

ing from such Orders and whose only interest, if any, is in the protection of the commission business derived from the sale of mutual fund shares.

All counsel reserve the right in their briefs to make some rephrasing of the tentative issues stated above, and to respond in their briefs to any matters raised in the briefs of the opposing parties. They agree that this stipulation shall not be construed as a waiver by any of them of any objection based on the ground that one or all of the points raised in the issues above stated are irrelevant, without foundation in the record, not properly preserved below, or otherwise not open to review.

II.

Procedures with respect to printing of the joint appendix.

It is contemplated that only the following portions of the record in this case before the Commission will require printing in the joint appendix:

1. Application of the First National City Bank, filed with the Commission August 24, 1965, pursuant to Section 6(c) for order of exemption from provisions of Sections 10(b)(3), 10(c), 10(d)(2), 15(a), 16(a), 17(f), 17(g) and 32(a)(2) of the Investment Company Act of 1940 (File No. 812-1823).
2. Notice of the Commission, dated September 2, 1965, of filing of application pursuant to Section 6(c) for an order of exemption from Sections 10(b)(3), 10(c), 10(d)(2), 15(a), 16(a), 17(f), 17(g) and 32(a)(2) of the Investment Company Act of 1940, in the matter of First National City Bank (Commingle Investment Account) (File No. 812-1823).
3. Order of the Commission, dated October 20, 1965, establishing the procedure for the filing of briefs and the presentation of oral argument respecting an application for an order of exemption from certain Sections of the Investment Company Act of 1940.

4. Motion for amendment, filed December 8, 1965, on behalf of the National Association of Securities Dealers, Inc.

5. Order of the Commission, dated December 17, 1965, denying motion and granting extension to December 28, 1965, for the filing of reply briefs.

6. Letter of the Comptroller of the Currency dated May 10, 1965, approving Commingled Investment Account, included as Exhibit A of brief of First National City Bank in answer to motion for amendment of National Association of Securities Dealers, Inc.

7. Findings, opinion and order of the Commission, dated March 9, 1966.

8. Correction of findings, opinion and order of the Commission, dated March 14, 1966.

9. Petition for rehearing filed March 14, 1966, on behalf of the National Association of Securities Dealers, Inc.

10. Order of the Commission, dated April 6, 1966, denying petition for rehearing.

It is further agreed that any party and the intervenor, in brief or at the hearing of the case, may refer to and rely upon any other portion of the record to the extent that such portion may be material to the issues, it being understood that any portion thus referred to will be reproduced in a supplemental joint appendix if the Court so requires.

MARC A. WHITE

Attorney for Petitioner

DAVID FERBER

Attorney for Respondent

SAMUEL E. GATES

Attorney for Intervenor

DATED: June 6, 1966.

Prehearing Order

Counsel for the parties in the above-entitled case having submitted their stipulation pursuant to Rule 38(k) of the General Rules of this Court, and the stipulation having been considered, the stipulation is approved, and it is

ORDERED that the stipulation shall control further proceedings in this case unless modified by further order of this court, and that the stipulation and this order shall be printed in the joint appendix herein.



BRIEF FOR PETITIONER

IN THE
United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 20,164

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent,*
FIRST NATIONAL CITY BANK, *Intervenor.*

On Petition To Review an Order of the
Securities and Exchange Commission

United States Court of Appeals
for the District of Columbia Circuit

FILED AUG 12 1966

Nathan J. Paulson
CLERK

MARC A. WHITE
General Counsel
National Association of
Securities Dealers, Inc.
888 17th Street, N. W.
Washington, D. C. 20006

JOSEPH B. LEVIN
Brown Lund & Levin
1625 Eye Street, N. W.
Washington, D. C. 20006

STATEMENT OF QUESTIONS PRESENTED

1. Whether the Securities and Exchange Commission exceeded its authority under Section 6(c) of the Investment Company Act in granting exemptions from Section 10 of that Act.

2. Whether the granted exemptions are consistent with the purposes fairly intended by the policy and provisions of the Investment Company Act and the protection of investors, and are necessary or appropriate in the public interest.

3. Whether the Commission may grant exemptions from Section 10 of the Investment Company Act unless it finds that the Committee here proposed will exercise the directorial functions contemplated by the Act, without which exercise investors would in effect be denied the companion statutory rights to vote and elect directors.

4. Whether the Commission failed to comply with the requirement of Section 8(b) of the Administrative Procedure Act that the basis for conclusions be stated.

INDEX

	Page
Jurisdictional Statement	1
Statement of the Case	3
Statutes Involved	6
Summary of Argument	6
Argument	8
I. The Commission's action contravenes the purpose and policy of Section 10 of the Act	8
A. The purpose of Section 10 generally	8
B. Section 10(c) of the Act	11
C. The Commission's decision	18
II. The Commission exceeded its authority under Section 6(c) of the Act	30
III. In any event, the Commission could not grant any exemptions from Section 10 of the Act unless it found, which it did not, that the Committee would exercise the directorial functions contemplated by the Act	33
Conclusion	40
Appendix	41

CITATIONS

CASES:

<i>American Trucking Association v. U. S., I.C.C.</i> , 364 U.S. 1 (1960)	32
<i>Cities Service Co. v. S.E.C.</i> , 247 F. 2d 646 (C.A. 2, 1957); <i>cert. denied</i> , 355 U.S. 912 (1958)	34
<i>Gilman v. Jack</i> , 148 Maine 171, 91 A. 2d 207 (Sup. Jud. Ct., 1952)	18
<i>Investment Company Institute, et al. v. James J. Saxon, Comptroller of the Currency, D.D.C., Civil Action No. 1083-66</i>	18

	Page
<i>Petroleum and Trading Corporation</i> , 11 S.E.C. 389 (1942)	10
<i>S.E.C. v. Capital Gains Research Bureau</i> , 375 U.S. 180 (1963)	17
<i>The Prudential Insurance Company of America</i> , Investment Company Act Release No. 3620 (January 22, 1963), <i>aff'd</i> 326 F. 2d 383 (C.A. 3, 1964), <i>cert. denied</i> , 377 U.S. 953	32, 35
<i>U. S. v. Mississippi Valley Generating Company</i> , 364 U.S. 520 (1961)	28, 30
<i>Variable Annuity Life Insurance Co.</i> , 39 S.E.C. 680 (1960)	32
 STATUTES AND RULES:	
Administrative Procedure Act, Section 8(b), Act of June 11, 1946, 60 Stat. 242, U.S.C.A., Title 5 § 1007 (b)	36
Banking Act of 1933, Section 32, Act of June 16, 1933, 48 Stat. 194; Aug. 23 1935, 49 Stat. 709, U.S.C.A., Title 12, § 78	12, 19
Federal Power Act of 1935, Sec. 305(b) Act of August 26, 1935, 49 Stat. 856, U.S.C.A., Title 16, § 825d(b)	12
Investment Company Act of 1940, Act of August 22, 1940, c. 686, 54 Stat. 789, <i>et seq.</i> , U.S.C.A., Title 15, § 80a-1 <i>et seq.</i>	
Section 1(b), 54 Stat. 789, U.S.C.A., Title 15, § 80a-1(b)	8, 29
Section 2(a)(3), 54 Stat. 790, U.S.C.A., Title 15, § 80a-2(a)(3)	9
Section 2(a)(8), 54 Stat. 790, U.S.C.A., Title 15, § 80a-2(a)(8)	3
Section 2(a)(31), 54 Stat. 790, U.S.C.A., Title 15, § 80a-2(a)(31)	4
Section 4, 54 Stat. 797, U.S.C.A., Title 15, § 80a-4	3
Section 5, 54 Stat. 800, U.S.C.A., Title 15, § 80a-5	3

	Page
Section 6(c), 54 Stat. 800, U.S.C.A., Title 15, § 80a-6(c)	2, 6, 30
Section 10(a), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(a)	5, 10, 20
Section 10(b), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(b)	2, 5, 10
Section 10(c), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(c)	<i>passim</i>
Section 10(d), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(d)	2, 25
Section 16(a), 54 Stat. 813, U.S.C.A., Title 15, § 80a-16(a)	33
Section 17, 54 Stat. 815, U.S.C.A., Title 15, § 80a-17	9
Section 18(i), 54 Stat. 817, U.S.C.A., Title 15, § 80a-18(i)	33
Section 43(a), 54 Stat. 844, U.S.C.A., Title 15, § 80a-42(a)	3
Public Utility Holding Company Act of 1935, Act of August 26, 1935, c. 687, 49 Stat. 837, U.S.C.A., Title 15, § 79, <i>et seq.</i>	8, 12, 18, 31
Regulation 9 of the Comptroller of the Currency, 12 CFR 9	38, 39
Rule 17 CFR 270 17d-1	9
Securities Act of 1933, Act of May 27, 1933, 48 Stat. 74, U.S.C.A., Title 15, § 77a, <i>et seq.</i>	26
Securities Exchange Act of 1934, Section 7, 48 Stat. 888, U.S.C.A., Title 15 § 78(h)	21
 MISCELLANEOUS:	
<i>Comptroller's Manual for Representatives in Trusts</i> 35,	38
Congressional Record	13
Federal Register	19
Hearings before a Subcommittee of the Committee on Banking and Currency, U.S. Senate, on S. 3580, 76th Cong. 3d Sess.	8, 10, 13, 14, 15, 16, 27, 28, 29, 30, 31

	Page
Hearings before a Subcommittee of the Committee on Banking and Currency, U.S. Senate, on S. 2704, 89th Cong. 1st Sess.	23, 24, 30
Hearings before a Subcommittee of the Committee on Government Operations, House of Representa- tives, 88th Cong. 1st Sess.	11, 22, 24, 30, 39
Hearings before a Subcommittee of the Committee on Interstate and Foreign Commerce, House of Rep- resentatives on H.R. 10065, 76th Cong. 3d Sess. 8, 13, 28, 29	22
H.R. 8499, 88th Cong. 1st Sess	22
H.R. 9410, 88th Cong., 1st Sess.	33
H.R. 7482, 87th Cong. 1st Sess.	13
House Report No. 2639, 76th Cong. 3d Sess.	31
<i>Interlocks in Corporate Management</i> , A Staff Report to the Antitrust Subcommittee of the Committee on the Judiciary, House of Representatives (March 12, 1965)	7, 14, 16
<i>Investment Trusts and Investment Companies</i> , Report of Securities and Exchange Commission	17, 29, 31
S. 3580, 76th Cong., 3d Sess.	13, 31
Senate Report No. 1775, 76th Cong., 3d Sess.	

IN THE
United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 20,164

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent,*
FIRST NATIONAL CITY BANK, *Intervenor.*

On Petition To Review an Order of the
Securities and Exchange Commission

BRIEF FOR PETITIONER

JURISDICTIONAL STATEMENT

This is a petition filed by the National Association of Securities Dealers, Inc. ("the Association") to review orders under the Investment Company Act of 1940 ("the

Act'')¹ entered by the Securities and Exchange Commission ("the Commission"). The First National City Bank of New York City ("the Bank"), the intervenor herein,² initiated the proceeding below with an application under Section 6(c) of the Act.³ The application (JA 2) requested exemptions from various provisions of the Act, including Sections 10(b)(3), 10(c) and 10(d)(2).⁴

In effect, except for nomenclature, the Bank proposed to sponsor an open-end investment company or mutual fund for which it would be the underwriter and investment adviser. The fund would have a portfolio of equity securities and would make a continuous offering to the public of common stock at current net asset value, on which basis the shares would also be redeemed.

There was no evidentiary hearing on the application. The Association and other participants, including the Bank, filed briefs and presented oral argument. The Association, as did others, opposed the grant of exemptions requested from Section 10.

The Commission in a Findings and Opinion and Order dated March 9, 1966, in substance, granted the exemptions requested except that from Section 10(d)(2) (JA 52). One Commissioner dissented from the grant of the exemptions (JA 68). In a Correction of Findings, Opinion and Order dated March 14, 1966, (JA 73) the Commission granted an exemption from Section 10(b)(2) of the Act.⁵ On March 14, 1966, the Association filed a petition for rehearing (JA 75), which the Commission denied by an Order dated April 6, 1966 (JA 77).

¹ Act of August 22, 1940, c. 686, 54 Stat. 789, *et seq.*, U.S.C.A., Title 15 § 80a-1, *et seq.*

² Intervention was permitted by this Court's order of June 3, 1966.

³ 54 Stat. 800, U.S.C.A., Title 15, § 80a-6(c).

⁴ 54 Stat. 806, U.S.C.A., Title 15, §§ 80a-10(b)(3), 10(c) and 10(d)(2).

⁵ 54 Stat. 804, U.S.C.A., Title 15, § 80a-10(b)(2).

The Association filed its petition for review on May 5, 1966.⁶ This Court has jurisdiction under Section 43(a) of the Act.⁷

STATEMENT OF THE CASE

In its application to the Commission, the Bank proposed a Commingled Investment Account ("the Account") to be operated as a collective investment fund pursuant to applicable regulations of the Comptroller of the Currency. The Account will register under the Investment Company Act as a diversified, open-end, management investment company (JA 2).⁸ The Bank, on a continuing basis and

⁶ The functions and activities of the Association constitute an integral part of the federal system of securities regulation. The Association is registered with the Commission under Section 15A of the Securities Exchange Act of 1934, Act of June 25, 1938, c. 677, 52 Stat. 1070, U.S.C.A., Title 15 § 78o-3(a), which authorized its creation. The Association has 3,700 members who are registered as brokers and dealers with the Commission under that statute. In accordance with the requirements of Section 15A, the rules of the Association are designed to promote just and equitable principles of trade and to prevent fraudulent practices on the part of underwriters and dealers in investment company securities as well as other securities. The Association has power to exclude or otherwise sanction its members found guilty of violation of the federal securities laws or of deceptive and manipulative practices upon the public. Under the Investment Company Act, the Association is given important functions and rule making power to ensure that member dealers in their dealings with investment companies do so without prejudice to such companies and their investors. Furthermore, the Association is engaged in policing, in respect of its members, the Commission's statement of policy as to what would be deemed misleading statements or omissions of material fact in sales literature used in the sale of shares of open-end investment companies.

The Bank sponsored investment company here involved will compete with existing open-end investment companies and those who sell the securities of such companies. Approximately 90% of the Association's members sell shares of open-end investment companies from time to time.

⁷ 54 Stat. 844, as amended, U.S.C.A., Title 15, § 80a-42(a).

⁸ The Commission pointed out that under "Section 2(a)(8) of the Act, a 'fund', such as the Account, is an investment company" (JA 55). Section 4 of the Act, 54 Stat. 797, U.S.C.A., Title 15 § 80a-4, classifies a management company as any investment company other than a face amount certificate company or a unit investment trust. Section 5 of the Act, 54 Stat. 800,

[continued on p. 4]

without a sales charge, will sell participations of \$10,000 or more in the Account, pursuant to an agreement between the investor and the Bank under which the Bank will act as managing agent (not as trustee) for the investor (JA 15). The funds in the Account will be invested principally in common stocks and securities convertible into common stocks (JA 16). The investor's interest in the Account will be represented by units of participation, with the proportionate interest of each investor expressed by the number of units allocated to him (JA 17). The value of a unit will be determined by its net asset value, i.e., the proportionate share such a unit represents of the total value of the net assets of the Account (JA 18). Participants will be entitled to redeem their units and receive the current net asset value (JA 21). Each unit will carry the right to one vote (JA 26).

Under a management agreement, to be approved by the participants at their first meeting, the Bank will maintain a continuous investment program for the Account and determine what securities are to be purchased and sold for the Account. For its services, the Bank will receive a fee, equal on an annual basis, to $\frac{1}{2}$ of 1% of the average net asset value of the Account (JA 26).

The operation of the Account will be subject to the supervision of a committee ("the Committee") of at least three persons with only one member unaffiliated with the Bank (JA 3, 15). The Committee, initially appointed by the Bank, will be elected by the participants at annual meetings (JA 3, 26).

It is for this Committee that exemptions were requested under Section 10 of the Act (JA 7), which relates to the

[continued from p. 3]

U.S.C.A., Title 15, § 80a-5, subclassifies a management company (i) as "open-end" if it offers for sale a "redeemable security", defined in Section 2(a)(31) of the Act, 54 Stat. 790, U.S.C.A., Title 15, § 80a-2(a)(31), as a security which entitles the holder to receive, either in cash or kind, his proportionate share of the issuer's net assets, and (ii) as "diversified" if its assets meet certain prescribed standards so that its investments consist primarily of a diversified portfolio.

composition of the board of directors of an investment company.⁹ The Commission denied the exemption from Section 10(d)(2) and granted the others.¹⁰ One Commissioner dissented from the grant of the exemptions. As a result of the denial, no more than 60% of the Committee's membership may be officers or directors of, or otherwise affiliated with, the Bank, as required by Section 10(a) of the Act.¹¹ The exemptions to which the Association objected, but which were granted by the Commission, relieved the Bank from the following statutory prohibitions:

(1) the majority of the board of directors of an investment company may not consist of persons who are officers or directors of any one bank—Section 10(c) of the Act, and

(2) a majority of the board may not be composed of persons who are investment bankers or their affiliates—Section 10(b)(3) of the Act. The Commission imposed a restrictive condition in this regard (JA 65).¹²

⁹ Section 2(a)(12) of the Act, 54 Stat. 790, U.S.C.A., Title 15, § 80a-2(a)(12), defines the term "director" to include "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated."

¹⁰ The Commission also granted exemptions from provisions of the Act other than Section 10 which were requested by the Bank and which were not opposed.

¹¹ 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(a).

¹² Since the Bank participates from time to time in syndicates underwriting United States Government and municipal obligations, it is an "investment banker", defined by Section 2(a)(20) of the Act, 54 Stat. 790, U.S.C.A., Title 15, § 80a-2(a)(20), as "any person engaged in the business of underwriting securities issued by other persons" (JA 64).

The Commission's subsequent Correction Order exempted the Bank from a comparable prohibition in Section 10(b)(2) of the Act as to the principal underwriter of an investment company's securities. The Commission found that the Bank was an underwriter with respect to the Account's securities (JA 74).

STATUTES INVOLVED

The relevant statutory provisions are set forth in an appendix hereto.

SUMMARY OF ARGUMENT

The Commission exceeded its authority under Section 6(c) of the Investment Company Act in granting exemptions from Section 10. The Commission must find that an exemption, in the language of Section 6(c), "is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act. The Commission's action contravened the purpose and policy of the statute.

Section 10 of the Act is one of the prophylactic measures embodied in the statute to prevent imposition by "insiders". To treat with the problem of conflicts of interest, actual or potential, Section 10 imposes various restrictions on the composition of a board of directors of an investment company. Section 10(c), which resulted from a history of gross abuse in the bank-investment company interlock, provides that a majority of the board of directors of an investment company may not consist of persons who are officers and directors of any one bank.

Here the existence of potential conflicts of interest between the Bank and the investment company is acknowledged, thus presenting the very type of situation to which Section 10(c) is directed. In these circumstances, the Commission had no warrant to invoke Section 6(c). That provision does not vest the Commission with a general dispensing authority. Whatever the breadth of its power under Section 6(c), the Commission may not undo the policy carefully and deliberately prescribed in Section 10(c). The Commission's action permits precisely that which the Congress concluded was against the public interest and contrary to the protection of investors—an investment company that is an adjunct of a bank.

The Commission did not find, nor could it, that the Committee (the ostensible board of directors) to be elected by investors would exercise the directorial functions contemplated by the statute. It simply "assumed" that this would be the case and thereby sought to avoid a fundamental matter of statutory compliance. But how can the Commission find that it is in the public interest and consistent with the protection of investors and the statutory policies, to permit a board of directors, composed in a manner authorized by the Commission, unless it is satisfied that the Board, however composed, will be assigned and perform the duties contemplated by the Act?

The companion statutory rights to vote and elect directors are satisfied, as the Commission itself has maintained, only if the investor is entitled to select the directors who have the ultimate responsibility for investment decision and management, the essence of an investment company's being. Here, although the Account will be under the Committee's "supervision", which is nowhere described and the details of which the Commission refused to elicit, the Account, as the Commission recognized, will be a department, and under the effective control, of the Bank. Furthermore, under the applicable banking regulations, the real management of the Account will not be the Committee, but the board of directors of the Bank. The investor, however, will have no voice in the election of the Bank's board, where it would be meaningful.

Having ignored this matter in its Findings and Opinion, the Commission, in its order denying our petition for rehearing, stated that "it had clearly indicated that in its opinion the banking laws or regulations did not preclude the exercise of [the Committee's directorial] duties." The Commission did not state the basis for this conclusion, as required by Section 8(b) of the Administrative Procedure Act. The Commission did not even refer to, let alone discuss, the pertinent banking regulations.

ARGUMENT

I. THE COMMISSION'S ACTION CONTRAVENES THE PURPOSE AND POLICY OF SECTION 10 OF THE ACT

To grant an exemption under Section 6(c) of the Act the Commission must find that it "is necessary or appropriate in the public interest *and* consistent with the protection of investors *and* the purposes fairly intended by the policy and provisions of this title." (Emphasis added)

A. The Purpose of Section 10 Generally.

The Commission's comprehensive study of investment companies which led to the passage of the Act revealed a history of abuse and imposition on the part of certain insiders.¹³ A paramount purpose of the Act is to prevent a recurrence of this spoliation and to treat with the problem of conflicts of interest, actual and potential, particularly as it relates to investment company directors and officers and their affiliates who are in a position to enjoy the emoluments and patronage which an investment company provides.¹⁴ Included in the statutory arsenal directed to

¹³ The Commission's study, *Investment Trusts and Investment Companies*, was undertaken pursuant to Section 30 of the Public Utility Holding Company Act of 1935, Act of August 26, 1935, c. 687, 49 Stat. 837, U.S.C.A., Title 15, § 792-4. The Commission's recommendations for legislation were embodied in S. 3580, 76th Cong. 3d Sess., which it drafted and which was the subject of detailed hearings before a Subcommittee of the Senate Committee on Banking and Currency ("Senate Hearings"). While the investment company industry did not oppose legislation as such, it objected to certain provisions of the bill. The Commission and the industry arrived at a compromise that took the form of S. 4108 and H.R. 10065, 76th Cong. 3d Sess. After hearings before the Senate Committee on the modified bill, a Subcommittee of the House Committee on Interstate and Foreign Commerce held hearings on H.R. 10065 ("House Hearings"). The legislation was enacted essentially in the recommended compromise form.

¹⁴ Section 1(b) of the Act, 54 Stat. 789, U.S.C.A., Title 15, § 80a-1(b) declares "that the national public interest and the interest of investors are adversely affected", *inter alia*:

* * *

"(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the

this end are two sets of complementary and supplementary prohibitions, one relating to so-called self dealing, Section 17 of the Act,¹⁵ and the other to the composition of the board of directors of an investment company, Section 10 of the Act.

Section 17 of the Act, as here relevant, in effect generally prohibits any "affiliated person" (defined in Section 2(a)(3) of the Act¹⁶ to include an investment adviser, officer, director, employee, 5% shareholder or controlling person) of an investment company, or any affiliated person of such an affiliated person, to sell to, or purchase from, the investment company any securities or other property, or to borrow from the investment company, or to effect a transaction in which the investment company is a joint participant.¹⁷ The Commission may permit a prohibited transaction upon a showing, *inter alia*, of the fairness of the transaction.¹⁸

The statutory prophylaxis, however, is not limited to this flat prohibition of transactions in which the potential conflict of interest is obvious. Section 10 embodies an even more pervasive preventive to protect the investing public from the pressures and temptations, oftentimes not

interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

* * *

It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors."

¹⁵ 54 Stat. 815, U.S.C.A., Title 15, §80a-17.

¹⁶ 54 Stat. 790, U.S.C.A., Title 15, §80a-2(a)(3).

¹⁷ Section 17(a) of the Act, Section 17(d) and Rule 17 CFR 270 17d-1 thereunder.

¹⁸ Section 17(b) of the Act and Rule 17d-1.

evident, generated by the mere existence of dual loyalties.¹⁹ Its provisions are designed essentially to immunize the board from domination by directors with certain business affiliations. Its function, as the Commission has pointed out, is "... to insure that a certain percentage of directors will not themselves possess affiliations which involve potentially conflicting interests."²⁰ Thus, the majority of the board of directors of an investment company may not consist of persons who are officers or directors of any one bank, Section 10(c), or who are regular brokers for the company or principal underwriters of its securities, or investment bankers, Section 10(b), or in each case persons affiliated with them; and no more than 60% of the board may consist of investment advisers to the investment company or affiliated persons of such advisers or officers or employees of the investment company, Section 10(a).

The Commission acknowledges in its Findings and Opinion, as discussed below, that there are potential conflicts of interest in the arrangement presented. It emphasized this conflicts problem before a Congressional committee in urging the need for the statute's application to this type of arrangement. The then Chairman of the Commission thus stated that "... there can be no doubt that potential areas of conflict between the fund and other aspects of the bank's

¹⁹ One Commission spokesman, L. M. C. Smith, in explaining the need for Section 10 stated:

"... some of the serious losses have come from people who have tried to carry water on both shoulders, whose integrity I do not attack, but who have tried to act in a dual capacity and serve their own interest at the same time they have served the investment trust." Senate Hearings, p. 207.

²⁰ *Petroleum and Trading Corporation*, 11 S.E.C. 389, 393 (1942) where the Commission denied an exemption from certain provisions of Section 10 because, as the Commission put it, "conceivably" a conflict of interest might arise in the circumstances presented.

Commissioner Robert E. Healy, who supervised the Commission's study, speaking of Section 10, stated: "... to prevent the evils which may result from the divided loyalties, certain specific restrictions are imposed on affiliations involving conflicts of interest." Senate Hearings, 44-45.

activities are present." Elaborating on this subject he called attention "very briefly [to] four areas of potential conflict":

"(1) Since the cash position of the fund's portfolio may be deposited in the bank and used to make money for the bank, care must be taken to see that the question of how much of the portfolio should be kept in cash is decided on the proper grounds. [This potential conflict is manifest here for the management agreement specifically provides: "The Bank will determine what portion, if any, of the Commingled Account should be held uninvested . . ." (JA 30).]

"(2) The fund has brokerage business to direct. We have learned that at present brokerage is often distributed by banks according to a formula which rewards those brokers who keep balances in the bank or have other business relations with the bank. This policy of the banks could lead to excessive portfolio turnover or to the fund not receiving the maximum benefit from its brokerage business.

"(3) As I mentioned before, fund investments could be used to shore up bank investments. [The earlier reference was that "the mutual fund could be used to provide the cushion for bank loans."]

"(4) Banks are underwriters and dealers in various kinds of Government bonds, many of which might be a suitable class of investments for the mutual funds they sponsor. It should be noted that the banks are making vigorous efforts to expand the permissible boundaries of their underwriting activities—most recently in the area of revenue bonds."²¹

B. Section 10(c) of the Act.

Before considering the Commission's effort to avoid the statutory consequences of the undeniable conflicts problem here presented, we shall discuss the background of Section 10(c). Its terms, policy and purpose make it clear

²¹ Hearings before a Subcommittee of the Committee on Government Operations, House of Representatives, 88th Cong., 1st Sess. (May 20, 1963), pp. 11-12, ("Government Operations Hearings").

that the Commission's action flies in the face "of the purposes fairly intended by the policy and provisions of this title", the language used in Section 6(c) of the Act.

Contrary to the Bank's assertion below that Section 10(c) is an "inadvertent provision" and "was not considered a very significant provision",²² a view which the Commission has at least tacitly endorsed by its action, Section 10(c) reflects a basic policy of the statute. The Section 10(c) prohibition, which would have been even more restrictive had the recommendation of commercial bankers been adopted, was proposed by the Commission and enacted by the Congress only after careful study and analysis. As described below, the demonstrated abuses and the conflicts that resulted from interlocking relationships between banks and investment companies compelled at a minimum the flat bar in Section 10(c) against *any* investment company being dominated by the management of one bank. The purpose and policy is manifest not only in the precise and unambiguous language of the statute but in the legislative history, which bristles with passages, almost in monotonous refrain, that condemn the bank-investment company interlock.²³

The Congress in summarizing the "more important" problems "which should be remedied by legislation" stated:

"Brokers, security dealers, investment bankers and *commercial banks* are in a position to dominate the board of directors and control the management of investment companies; and thus, when they are un-

²² Transcript of oral argument, pp. 61 and 71.

²³ Section 10(c) is another manifestation of the overall Congressional apprehension of banker infiltration and domination stemming from the experiences of the twenties, which finds expression in varying restrictions in other statutes. E.g., Public Utility Holding Company Act of 1935, see note 66, *infra*; Banking Act of 1933, see p. 19, *infra*; Federal Power Act of 1935, Sec. 305(b), Act of August 26, 1935, 49 Stat. 856, U.S.C.A., Title 16, § 825d(b).

scrupulous, to advance their own pecuniary interests at the expense of the investment companies and their security holders." (Emphasis added)²⁴

The Congress described the remedy it selected in the following unequivocal language:

"Hereafter the majority of the board of directors of an investment company may not consist of persons who are officers or directors of any one bank . . ."²⁵

The reason the Commission recommended Section 10(c) was explained during the Congressional hearings by David Schenker, chief counsel for the Commission's study:

"Subsection (c) . . . was inserted not only on the basis of our study, but after conferences with the Federal Reserve Board. There were very undesirable consequences flowing from interlocking directorships or interlocking relationships between commercial banks and investment companies. *Some of the worst examples of abuses we had in the whole study arose out of that relationship* and the Federal Reserve Board, as well as ourselves, felt that in the future, there should not be that close relationship. The adversities of the investment trust may have harmful effects on the bank such as runs on the bank. They are so intimately tied up." (Emphasis added.)²⁶

* * *

²⁴ Senate Report No. 1775, 76th Cong. 3d Sess. ("Senate Report"), p. 7. Commissioner Healy made almost an identical statement at p. 58 of the House hearings.

²⁵ Senate Report, p. 14. The identical statement was made during the presentation before the House of Representatives, 86th Cong. Record, Part 9, p. 9810. To the same effect, see House Report No. 2639, 76th Cong. 3d Sess. ("House Report"), p. 14.

²⁶ House Hearings, pp. 110-111. Mr. Schenker explained that the "grandfather clause" in Section 10(c) was not to be extended and was not intended to derogate from the importance of the Section 10(c) prohibition, but was a concession compelled by circumstance, i.e., ". . . because of the delicate relationship involved between banks and investment companies, we said we would not recommend that the status quo be disturbed . . ." Senate Hearings, p. 885.

"The study showed that interlocking relationship between investment companies and banks was a very unhealthy relationship both from the point of view of the bank and from the point of view of the investment trust * * * [O]ur study shows that it is not very satisfactory as far as the investment company or bank is concerned to put it mildly."²⁷

L. M. C. Smith, associate counsel for the Commission's study, in discussing Section 10 and its effort to deal with the conflicts of interest problem, stated:

"Now, the situation in regard to these people, such as the managers and brokers and people like that, becomes *more acute* in the case of the investment banker and also *in the case of the commercial banker . . .*" (which he then illustrated with case histories) Emphasis added.²⁸

Commissioner Robert E. Healy, in reviewing the Commission's study which he supervised, stated:

"Subordination of the interest of security holders to those of promoters and management takes many forms. * * * Investment companies have been compelled to finance banking clients of the insiders, and

²⁷ Senate Hearings, p. 885. Mr. Schenker described a situation where officers and directors of a bank who also held similar positions with an investment company "used the investment funds to try to stabilize the bank stock because they were afraid of a run." Senate Hearings, p. 221.

A Commission memorandum dealing with companies that did not file questionnaires or summary statements in connection with the Commission's study declares: "The experience of bank-sponsored or affiliated trusts included in this section of the Commission's report appears to have been almost uniformly disastrous." Senate Hearings, p. 793. See also *Investment Trusts and Investment Companies*, Part III, Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies, pp. 115-181 for detailed case histories.

²⁸ Senate Hearings, p. 207. Mr. Schenker, commenting on this testimony, stated:

"Take Mr. Smith's case of the loans to the bank officers. They loaned money to officers and directors, who got into margined accounts and gambled their heads off with investment-company funds and bank funds." Senate Hearings, p. 804.

companies in which they were personally interested. * * * The public's funds are used to further the banking business of the insiders . . . and otherwise to serve the personal interests of the sponsors and management.'²⁹

The Commission's presentation was so persuasive that Senator Robert F. Wagner, Chairman of the Committee, was led to conclude:

" . . . I would think it would be better if the entire board were free of any kind of influence from bankers; because I think you can get other men. Of course, I know that is ideal and that we are not going to get that far; but then there would be no chance about their loyalty being consciously or subconsciously only to their investment trust rather than to outside interests * * * I still say there should be complete separation, and that in the long run it will serve a better purpose."³⁰

Nor was Senator Wagner alone in his view. The Commission's L. M. C. Smith testified that this was the view too of commercial bankers but that a "middle road" approach was taken by the Commission:

"I think there is nothing so clear as the fact that this relationship between the banks and the investment companies has proved unfortunate. The president of the Liberty Bank said there ought to be absolute segregation. The head of the M & T Bank said the same thing. The head of the Central Illinois said that the relationship was unsatisfactory. I do not think there is any question about it so far as our record is concerned."³¹

* * *

²⁹ Senate Hearings, p. 37.

³⁰ Senate Hearings, p. 222.

³¹ Senate Hearings, pp. 885-886. Mr. Schenker added that the "directors of the Chatham & Phoenix Bank, which also had an investment trust, said it was a very undesirable and unfortunate relationship." Senate Hearings, p. 886.

"... I can show you various people in the industry who have appeared in our hearings, and otherwise, who have advocated complete segregation of the investment banker and commercial banks from investment companies, so that the position we take is a middle-road one between no regulation and complete segregation."³²

As Commissioner Healy put it, Section 10 was a "compromise",

"... instead of ... having a complete segregation of investment bankers or commercial bankers or brokers, an attempt was made to permit it and then to circumscribe it."³³

Further evidence that Congress meant the lines it drew in Section 10(c) to be enforced, and not tampered with, is the evolution of the provisions relating to the bank interlock. Under the original bill proposed by the Commission, the type of prohibition now contained in Section 10(c) was

³² Senate Hearings, p. 217. In hearings conducted by the Commission in connection with its study, one bank official, in light of his experience, testified:

"... I think very decidedly it is a mistake for an officer of a commercial bank to have any connection with an investment trust. * * * I am absolutely opposed to a commercial bank engaging in the investment business in any way. I don't think the two mix. Mr. Dawes [Henry M. Dawes, a former Comptroller of the Currency, who had been associated with the witness] referred this morning to the department store angle of commercial banks, which I think probably expresses the tendency upon the part of commercial banks to engage in altogether too broad a service a few years ago ... [A]side from a trust business, I feel a commercial bank should confine itself strictly to a bank of deposit and a bank making short-term commercial loans."

Mr. Dawes commented:

"I don't believe that any of us associated with that group of interests out there had an interest or desire to get into this sort of departmental banking that we did. But it just grew out of this competitive situation." *Investments Trusts and Investment Companies*, Part III, pp. 178, 179, 181.

³³ Senate Hearings, p. 1049.

not limited to banks but applicable to all types of companies²⁴ so that "no longer should an investment trust be an adjunct to somebody else's business."²⁵ While the prohibition in its general terms was eliminated, it was retained with respect to banks. An investment company was simply not to be an "adjunct" of a bank.

In addition, Congress considered other aspects of the bank interlock problem. The original bill would even have prohibited a director or officer of a bank from serving as investment officer or manager of an investment company.²⁶ This restriction may not have survived on the premise that since the bank could not dominate the investment company board, the bank official would be subject to surveillance by an independent board, a condition which would not prevail under the Commission's decision.

The "intent of Congress must be culled from the events surrounding the passage of the 1940 legislation."²⁷ And the foregoing demonstrates with a certainty that Congress intended the flat and inexorable prohibition contained in Section 10(c). Experience compelled it, if indeed not even a more stringent proscription, as previously indicated. The metes and bounds of a bank's relationship to an investment company were carefully considered and hammered out. The statute expresses the Congressional determination that an investment company shall not have a board dominated by the directors and officers of any one bank. And a bank may function only within these permissible limits. The Congress concluded that this was

²⁴ Section 10(a)(1), S. 3580.

²⁵ David Schenker, Senate Hearings, p. 878.

²⁶ Section 10(d)(2), S. 3580.

²⁷ *S.E.C. v. Capital Gains Research Bureau*, 375 U.S. 180, 199-200 (1963).

necessary in the public interest and for the protection of investors.³⁸

Certainly on the record before it, containing acknowledged conflicts of interest, the Commission had no warrant to invoke Section 6(c) and undo this Congressional policy. Section 6(c) is a vehicle for effectuating, not frustrating, statutory principles, as is more fully discussed below.

C. The Commission's Decision.

Although the Commission attempted to rationalize a basis for asserting that there was no need for applying Section 10(c), a matter which we shall analyze below, the moving consideration for its conclusion, in our opinion, is to be found elsewhere. To understand the Commission's action, the Bank's application must be examined in the setting of certain innovations under the banking laws because they became the Commission's primary concern, rather than Section 10(c) of the Act, which should have been the Commission's sole point of focus. This misplaced emphasis, in our opinion, is attributable to the Commission's wholly irrelevant desire, however well intentioned, to avoid a legislative contest.

Prior to 1963 national banks were not permitted to commingle managing agency accounts and create a fund such as here involved. This innovation was introduced by the Comptroller of the Currency following the transfer to him in 1962 of regulatory authority over the trust and fiduciary functions of national banks (JA 56).³⁹ Until then this au-

³⁸ In *Gilman v. Jack*, 148 Maine 171, 91 A. 2d 207, 209 (Sup. Jud. Ct. Maine, 1952), the court in commenting on a related provision in the Public Utility Holding Act of 1935 stated:

"It makes no difference how high minded or otherwise qualified a person may be. If he comes within one of the prohibited classes enumerated, he is barred from holding office."

³⁹ The authority of the Comptroller of the Currency to permit this activity is being challenged in *Investment Company Institute et al. v. James J. Saxon, Comptroller of the Currency*, D.D.C., Civil Action No. 1083-66.

thority had been vested in the Federal Reserve Board, which had refused to permit an arrangement such as is here involved and the consequent excursion by banks into the investment company business.⁴⁰ The Board continues to have authority for the administration of Section 32 of the Banking Act of 1933, which prohibits any individual associated with a corporation primarily engaged in the "issue, flotation, underwriting, public sale or distribution . . . of . . . securities" from serving as an officer, director or employee of any member bank of the Federal Reserve system (JA 57).⁴¹

The Board has consistently taken the view that the interlocking relationship described in Section 32 between open-end investment companies and member banks is prohibited (JA 71). However, in a ruling obtained by the Bank, the Board found no violation of Section 32 because, as the Board stated, it understood from the Bank's representations that the Account would "be operated under the effective control of the bank", and it concluded that "the bank and Account would constitute a single entity for purposes of Section 32 . . . since Account would be regarded as nothing more than an arm or department of the bank."⁴² In other words, the Board's ruling is premised on the fact that the Account is part and parcel of the Bank. This, of course, is the very condition Section 10(c) outlaws.

The Commission's overriding concern, for which it was willing to sacrifice Section 10(c), was the preservation of the Bank's position before the Federal Reserve Board and the ruling it produced. The Bank was in a quandary. It had persuaded the Federal Reserve Board to conclude that the Bank and the Account would constitute a single entity;

⁴⁰ Government Operations Hearings (note 21, *supra*) pp. 5-6.

⁴¹ This prohibition is one of a series of provisions in the Banking Act of 1933 designed to divorce commercial banking from investment banking (JA 71).

⁴² 30 Federal Register, No. 195 (October 8, 1965) 12836.

if they were separate entities and conducted as such, Section 32 obviously would be violated under the Board's consistent rulings. On the other hand, before the Commission, the Bank had to recognize that under the Investment Company Act the Account is an entity separate from the Bank (JA 55) and must have a board of directors which meets the requirements of Section 10. But, as the Commission full well appreciated, if the Account were to comply with Section 10(c), the underpinnings of the Bank's position before the Board would be struck down. The Commission concluded that it would resolve the Bank's dilemma by abandoning Section 10(c) of the Investment Company Act.

The paramount concern of the Commission is evident from its Findings and Opinion. Thus, in refusing to grant the exemption which would have permitted the Committee to have but one unaffiliated member, and instead requiring that at least 40% of the Committee be unaffiliated as provided in Section 10(a) of the Act (see p. 10, *supra*), the Commission stated:

"We are not persuaded on the basis of the submissions before us that an exemption from Section 10 (d)(2) is necessary to enable the Bank to create and operate the Account under the rulings of the banking authorities or is otherwise necessary or appropriate in the public interest. The approval of the Bank's proposal by the Comptroller and the Federal Reserve Board does not appear to preclude more than one unaffiliated member on the Committee, provided, as stated by the Board, the Account will, 'be operated under the effective control of the bank.' " (JA 66)

This passage is the key to the Commission's approach. The requirements of the Investment Company Act were to be honored only insofar as they would not jeopardize the ruling the Bank had obtained. Since compliance with Section 10(c) would produce an irreparable impairment, it was subordinated and ignored.

The Commission's approach was based on a misconception as to its functions in enforcing Section 10(c). This is clear from its action and as amplified by the following statement of the Commission to a Congressional Committee made contemporaneously with the issuance of the Commission's Findings and Opinion:

"There are those who believe that this expansion of the investment activities of banks should, as a matter of national policy, not be permitted. I do not dismiss this view which may present significant policy issues, but I do not think it is a question for the Commission. * * * I believe the policy questions as to whether or not this is an appropriate banking function should be left to the Federal bank regulatory agencies subject of course, to the ultimate control of the Congress."⁴³

The Commission cannot abdicate its role in the enforcement of Section 10(c) by in effect taking the position that the subject matter of that provision is one of banking regulation for which it has no responsibility, and calling attention, as it did in its Findings, to the fact that the bank regulatory agencies considered the arrangement consistent with the statutes they administer (JA 56-57). The stewardship of the Investment Company Act rests with the Commission alone.⁴⁴ The Act sets limits on a bank's entry into the investment company business, which the Commission has no alternative but to enforce whatever may be the pleasure of bank regulatory authorities. It may not waive those limits and, notwithstanding its protestations to the contrary, make a determination of the "significant policy issues" involved in a manner which

⁴³ See note 46, *infra*.

⁴⁴ Where Congress intended a division of responsibility under the securities laws it was done by statute. For example, margin requirements are fixed by the Federal Reserve Board under Section 7 of the Securities Exchange Act of 1934, Act of June 6, 1934, 48 Stat. 888, U.S.C.A., Title 15 § 78(h), but they are enforced by the Commission.

countermands and nullifies the Congressional mandate embedded in a statute which it alone administers.⁴⁵

The policy of Section 10(c) has remained inviolate in the more than a quarter of a century since the Act's passage. Contrary to the Commission's view indicated below, Section 10(c) does embody one of the "essential protections" of the statute. It is not for the Commission to determine whether Section 10(c) should be annulled because the Comptroller of the Currency has recently authorized banks to enter the mutual fund business, and because the Federal Reserve Board will presumably only permit the conduct of such a business in a manner that would result in a violation of Section 10(c) of the Act. The Commission is simply without power to abridge Section 10(c) and to effect an "accommodation" of the Act, as it has characterized its action, so that it may avoid a legislative contest with the risk of a result which it deems unwise.⁴⁶

⁴⁵ A Commission statement contemporaneous with the issuance of the Commission's opinion, see note 46 *infra*, states: "A pattern has thus been set which other banks may follow if they see fit."

⁴⁶ The Commission's action here is an unusual deviation from its customary sensitivity to the policy of the Act. See note 20, *supra*. Its Findings, which are analyzed below, are unlike the reasoned and detailed analyses which have become a hallmark of its decisions. In our opinion, the Commission's action under Section 10 and its uncharacteristic by-passing of the issue covered in part III of the Argument herein can be explained only as an expedient adopted to contend with the contemporary legislative setting in which proposals were being pressed to exempt completely from the securities laws the type of arrangement here involved. It is evident that the Commission's action on the Bank's plan determined whether certain banking authorities would support the legislative proposals to which the Commission was unalterably opposed.

The Comptroller of the Currency had initially taken the position that an arrangement such as here involved was subject only to the banking regulations, and not to the securities laws. The Commission argued that the arrangement was subject to the securities laws. The matter was the subject of hearings in 1963 by a Subcommittee of the Committee on Government Operations, House of Representatives, 88th Cong. 1st Sess., which issued a report (No. 429) that supported the Comptroller. In 1964, H.R. 8499 and H.R. 9410, 88th Cong., 1st Sess., both of which proposed exempting the arrangement from the securities laws, were the subject of hearings before

We shall now analyze the three matters to which the Commission referred by way of justifying its action under Section 10(c).

1. The Commission stated:

"Although Section 10(c) is general in terms, it does not appear that it was directed at the type of open-end investment company represented by the Account. We have already pointed out that it was not until 1963 that a commingled account such as the Bank proposes to establish became possible. Moreover, as stressed by the Bank, it is clear that the Account is substantially different, both in purpose and nature of operation, from the bank-dominated investment companies described in this Commission's Report . . ., which led to the passage of the Act, and in the testimony at the Congressional hearings. As detailed in that Report * * * [such companies] frequently took the form of closed-end investment companies [i.e., which do not make a continuous offering of stock and the stock of which does not provide redemption rights] . . ." (Footnotes omitted. JA 60).

the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, at which the Comptroller renewed his earlier position. In 1965, S. 2704, 89th Cong., 1st Sess., providing for similar exemption was introduced. Hearings on the bill were held before a Subcommittee of the Committee on Banking and Currency, U. S. Senate, on March 8, 10, and 11, 1966. The Commission was scheduled to appear on March 11; the Findings in this matter were issued the day before. At the March 11 hearing, the Comptroller, who had been a moving sponsor of S. 2704, submitted a statement in which he referred to the cooperation of his office and the Commission and to the Commission's action herein. He then stated that S. 2704 would serve no useful purpose (Hearings, p. 130). The Federal Deposit Insurance Corporation and the Treasury Department, both of whom favored expansion of bank activities, advised that action on S. 2704 be deferred to await the outcome of the Bank's application before the Commission (Hearings, pp. 25, 27). The Commission submitted a statement which declared that:

"... the proper way to resolve questions as to the application of the Investment Company Act to these accounts, is to seek an accommodation which will preserve the essential protections of the Investment Company Act while at the same time reconciling this objective with the patterns and needs of bank regulation. * * * I am happy to say that a procedure has been worked out which will, I believe, bring about such an accommodation without the wholesale sacrifice of investor protection which S. 2704 would entail." (Hearings p. 137).

The fact that the form of open-end investment company under consideration did not become permissible until 1963, when the Comptroller of the Currency relaxed a long standing policy under the banking regulations, is no reason to abandon Section 10(c). As the Commission has steadfastly maintained in resisting proposals to exclude from the securities laws the type of arrangement here involved,⁴⁷ the critical fact is that the Account, except for nomenclature, is a mutual fund. For that reason it is subject to Section 10(c) no less than to the other provisions of the statute from which the Commission has properly refused to depart, giving no heed to the plea that this particular form of company was not in existence in 1940 when the statute was enacted.

If in the above quotation the Commission means, as the Bank had argued below, that Section 10(c), the terms of which embrace *any* registered investment company, was intended to apply only to closed-end investment companies, then the Commission, without reason, is truncating the statute. There is not a shred of legislative history to support this contraction of the statute. This approach is premised on the fallacious hypothesis that since abuses were demonstrated in bank-sponsored closed-end companies, Congress did not intend to impose the same prophylactic and remedial standards in dealing with the problem of conflicts and temptations in any other type of bank-sponsored investment company.

This novel and fettering approach to construing a remedial statute is unwarranted. As has been shown, Congress in Section 10(c) was concerned with the conflicts problem resulting from bank domination of investment companies. It was this problem, however it manifested itself and without regard to the species of the investment company involved, that was the Congressional concern.

⁴⁷ E.g., Hearings on S. 2704 (note 46, *supra*), p. 136 and Government Operations Hearings (note 21, *supra*) pp. 8-9.

Section 10(c), therefore, means exactly what it says; its terms are not inadvertent.

The Investment Company Act is very precise in delineating the type of investment company to which particular provisions are applicable. It carefully and discriminately employs terms such as open-end company, closed-end company, registered investment company, and management company in different provisions depending upon their intended scope. Indeed, the statute's precision on the very type of point here involved is demonstrated by subsection (d) of Section 10, which provides an exemption from Sections 10(a) and 10(b)(2) for a special type of investment company. The first qualification in Section 10(d) is that the registrant must be an open-end company. This specific designation of the type of investment company was added in the revision of the bill so that there would be no doubt about the section's coverage. Moreover, if Section 10(c) had been intended not to apply to open-end companies, it would have been included with the other exemptions from provisions of Section 10 enumerated in Section 10(d), which by its terms applies only to open-end companies. Furthermore, when the legislation was being considered, Section 10(c)'s application to open-end companies was understood and its need questioned by the open-end industry,⁴⁸ but the provision was not changed.

2. The Commission next referred to the conflicts of interest problem, the presence of which it acknowledged. It expressed the opinion that "the Bank has shown that substantial safeguards are present here against conflicts of interest which could arise as a result of the Bank's commercial banking activities." (JA 62). The Commission called attention to the existence of supervision by the banking authorities, and to the fact that the Bank, while not a trustee, will as managing agent be subject to fiduciary

⁴⁸ Senate Hearings, 659. See also p. 573.

responsibilities (JA 62). Insofar as the specific items of conflict referred to above (at p. 11) are concerned, the Commission concluded that they would be reached by prohibitions in the Investment Company Act such as those relating to self-dealing and joint ventures contained in Section 17 of the Act and by prohibitions in the regulations of the Comptroller of the Currency, as well as by disclosures in the Account's prospectus under the Securities Act of 1933 (JA 63).⁴⁹

The significance that can be assigned to the supervision by the banking authorities, the only point of difference between the Account and any investment company, is indicated by the Commission's own statement in its Findings that "banking oversight is of course not the same in scope or orientation as the protective provisions of the Act . . ." (JA 62). Next, we assume that by the reference to the fiduciary responsibilities of the Bank as managing agent, the Commission did not mean that these responsibilities are any greater than those deemed applicable by the Commission in any investment company relationship. Insofar as reliance was placed on prospectus disclosures, the Congress pointed out that while the Securities Act does provide for publicity, the "record is clear that publicity alone is insufficient to eliminate malpractices in investment companies."⁵⁰

Essentially, therefore, the Commission must find the "substantial safeguards" in prohibitory provisions of the statute such as Section 17. But these provisions are not a substitute for Section 10. This was made clear by Professor E. Merrick Dodd who discussed this very point in his testimony on the legislation. Thus, Professor Dodd stated:

"It has been urged that the prohibition against self-dealing, which is contained in Section 17, makes the

⁴⁹ Act of May 27, 1933, 48 Stat. 74, U.S.C.A., Title 15, § 77a.

⁵⁰ House Report, p. 10.

prohibition of interlocking directors, contained in Section 10, unnecessary; but the prohibition against self-dealing is not self executing, and the history of American corporate finance plainly demonstrates that such prohibitions are very difficult to enforce."⁵¹

In the same vein, he also pointed out:

"Well, now it may be asked, and I think it has been asked by people who have appeared before you: Why that double-barreled protection?" If you have a provision against self-dealing, why not stop there? Well, as I see it, for two reasons: In the first place, it is one thing to prohibit self-dealing and another thing to make that prohibition genuinely effective.

"We have had prohibitions against self-dealing in corporation laws for generations, and self-dealing has gone on. It is very hard to stop it . . . because it is very easy to conceal."⁵²

By its action, the Commission vitiates the "double barreled protection" purposefully built into the statute. The Commission misses the point of Section 10. As the Supreme Court has cogently stated in considering another conflicts of interest provision:

"The moral principle upon which the statute is based has its foundation in the Biblical admonition that no man may serve two masters, Matt. 6:24, a maxim which is especially pertinent if one of the masters happens to be economic self-interest. Consonant with this salutary moral purpose, Congress has drafted a statute which speaks in very comprehensive terms. . . . The statute is thus directed not only at dishonor, but also at conduct that tempts dishonor. This broad proscription embodies a recognition of the fact that an impairment of impartial judgment can occur in even the most well-meaning men when their personal economic interests are affected . . . To this extent, therefore, the statute is more concerned with what

⁵¹ Senate Hearings, p. 779.

⁵² Senate Hearings, p. 767.

might have happened in a given situation than with what actually happened. It attempts to prevent [the] honest . . . from succumbing to temptation by making it illegal for them to enter into relationships which are fraught with temptation."⁵³

Conflicts of interest can be subtle and not alone of the obvious type reflected in transactions that are specifically prohibited by the statute. As Professor Dodd indicated, they are "very easy to conceal". "Nor can the exact form of future conflicts be anticipated", as emphasized by dissenting Commissioner Budge (JA 70). In this connection it may be noted that one of the reasons that Section 10(b)(3) prohibits investment bankers from dominating the board, which is equally applicable to commercial bankers, is that the banker may use the investment company as a "bird dog",⁵⁴ i.e., he "may be impelled to have the investment company make an investment, not based upon the quality of that investment, but because the particular investment may give him an 'in' to get the banking business from the company whose securities the investment company bought."⁵⁵ In these circumstances, the investment company would be operated "in the interest of . . . persons engaged in other lines of business", which as Section 1(b) of the Act⁵⁶ declares, adversely affects the public interest and interest of investors.⁵⁷

⁵³ *U.S. v. Mississippi Valley Generating Co.*, 364 U.S. 520, 549-550 (1961).

⁵⁴ L. M. C. Smith, Senate Hearings, p. 222.

⁵⁵ David Schenker, House Hearings, p. 110.

⁵⁶ See note 14, *supra*.

⁵⁷ In considering the exemption from Section 10(b)(3) of the Act the Commission declared: "We do not think there is any basis for concern that the Bank, *qua* investment banker, can or will use the Account to its advantages . . ." (JA 65). The Commission's clairvoyance, with its confident certitude, interestingly enough is limited to the Bank "*qua* investment banker." The Commission carefully refrained from any such prediction as to the Bank, *qua* commercial banker.

The Commission was also in error in granting the exemption from Section 10(b)(3) of the Act. The Commission's approach to Section 10(b)(3)

Section 10(c) is a shield to protect investors against all conflicts in the bank interlock, whether evident or subtle, existing or potential. The provisions in the statute prohibiting certain specific transactions were not intended to, nor may the Commission rely upon them, as a substitute for compliance with Section 10(c).

3. Lastly, the Commission stated:

" . . . we have also taken into account the fact that Congress contemplated some relationships between banks and investment funds . . . For example, a common trust fund . . . maintained by a bank . . . in its capacity as trustee . . . is expressly excluded from the definition of an investment company by Section 3(c)(3) of the Act . . . In addition, Section 10(c) of the Act expressly permits a minority of the board of directors of a registered investment company to be officers and directors of a bank and nothing in the Act prohibits a bank from acting as investment adviser to an investment company . . ." (JA 63-64).

In this startling passage, the Commission in substance is saying that since the statute delineates the limits of a bank's association with an investment company, the Commission is warranted in permitting a bank to exceed those limits. We have already analyzed in detail the evolution of Section 10(c) to which the Commission made not even a reference and which refutes the Commission's inferences. The Commission converts the "middle road" approach

basically paralleled the fallacious approach it used in considering Section 10(c). It is evident from the legislative history cited above that the matter of investment banker domination of an investment company board was also of great concern. The Commission here too considered recommending segregation (Senate Hearings, pp. 44 and 1049) and originally urged more restrictive provisions than now contained in the statute (Sections 10(c), (e) and 10(f), S. 3580). The whole matter of the investment banker was extensively discussed by representatives of both the Commission (e.g., Senate Hearings, pp. 109, 209-214, 222, 402, 878 and 887) and the industry (e.g., Senate Hearings, pp. 409-417, 577-578 and 644-645). The present provision was agreed upon in the compromise which the statute reflects (House Hearings, p. 97). It is to be noted that the Bank, under the management agreement "will determine what portion, if any, of the Commingled Account . . . should be invested in Government obligations" (JA 30).

embodied in Section 10(c), but for which there could have been complete segregation of bank officials from investment companies, into the very integration that was condemned and manifestly not intended to continue.

Nor is it clear what support the Commission finds in the statutory exemption for common trust funds. The Commission has consistently maintained that the arrangement here involved is such a departure from the exempt common trust fund that the reliance on that exemption as a reason for not subjecting the arrangement to the statute is misplaced.⁵⁸

In conclusion, in Section 10(c) "Congress intended to establish a rigid rule of conduct . . ."⁵⁹ It meant to proscribe broadly for good reason, as we have shown. The "horrible" examples⁶⁰ of the bank dominated investment company led the Commission to recommend, and the Congress to adopt, an inexorable prohibition against a bank dominating any investment company. An investment company was simply not to be an adjunct of a bank. It is not for the Commission to disregard the statute's mandate and to substitute its policy judgment for that of the Congress.⁶¹

II. THE COMMISSION EXCEEDED ITS AUTHORITY UNDER SECTION 6(c) OF THE ACT

Section 6(c) does not grant the Commission a general dispensing authority. Section 6(c) declares that an exemption may be granted where "necessary or appropriate in the public interest" and "consistent with the protection of investors", as well as "the purposes fairly intended by

⁵⁸ E.g., Government Operations Hearings (note 21, *supra*), pp. 16-17; hearings on S. 2704 (note 46, *supra*), p. 136.

⁵⁹ *U.S. v. Mississippi Valley Generating Co.*, *supra*, 364 U.S. at 551.

⁶⁰ David Schenker, Senate Hearings, p. 970.

⁶¹ As dissenting Commissioner Budge stated:

"If the specific prohibition of the Congress in this broad policy area is to be avoided, it should be done by the Congress and not through the granting of ad hoc exemptions by the Commission." (JA 70)

the policy and provisions of this title." This last phrase did not appear in the original bill.⁶² It was added in the revised bill undoubtedly to impress in the statute the Commission's general position that it was not seeking, as certain industry spokesmen had claimed,⁶³ "unbridled discretion", which the Commission recognized would be unconstitutional.⁶⁴

Commission spokesmen made clear the limited purpose of Section 6(c). Thus,

"The only thing that this provision says is—if conditions exist or arise which *manifestly* are not within the legislative intent of this legislation, then the Commission should be in a position to exempt those in that situation" (Emphasis added)⁶⁵

" . . . this was put in here not to give the Commission additional power or prestige or anything of the sort, but simply so that we could deal with the unpredictable situation where a kind of company turned up—a kind such as none of us had thought of—that ought not in fairness be made subject to the statute."⁶⁶

⁶² Sec. 6(c), S. 3580.

⁶³ E.g., Senate Hearings, pp. 388, 571, 583 and 607-608.

⁶⁴ Commissioner Healy, Senate Hearings, pp. 45, 232, 1050.

⁶⁵ David Schenker, Senate Hearings, p. 197.

⁶⁶ Commissioner Healy, Senate Hearings, p. 872. The Senate Report (p. 13) stated that the Section 6(c) exemption was for "persons who are not within the intent of the proposed legislation."

In contrast with Section 10, Section 17(c) of the Public Utility Holding Company Act of 1935, 49 Stat. 830, U.S.C.A., Title 15, § 79q(c), which deals with a similar subject, specifically empowers the Commission to adopt exemptive rules. The latter statute was considered in connection with the drafting of the Investment Company Act, but comparable rule making authority was not provided in the Investment Company Act. This distinction was recently called attention to in *Interlocks in Corporate Management*, A Staff Report to the Antitrust Subcommittee of the Committee on the Judiciary, House of Representatives (March 12, 1965), p. 42, which in discussing Section 10 stated: "The [Investment Company] Act, unlike the Public Utility Holding Company Act, and other similar enactments, does not contain a general enabling clause that permits the SEC to define classes of exempted relationships. Except for subsection 10(f), the act itself defines and sets forth the classes of relationships that are exempt from its prohibitions."

The Commission has recognized that the Section 6(c) "authority must not be exercised in a manner which would permit the basic objectives of the Act to be thwarted." *Variable Annuity Life Insurance Co.*, 39 S.E.C. 680, 685 (1960). Similarly, in *The Prudential Insurance Company of America*, Investment Company Act Release No. 3620, p. 14 (January 22, 1963), *aff'd* 326 F. 2d 383 (C.A. 3, 1964), *cert. denied*, 377 U.S. 953, the Commission stated:

"As we have noted on prior occasions, this section [6(c)] was designed for exceptional situations where compliance is not necessary to accomplish the Act's objectives and policies; the authority conferred must be exercised with circumspection."

Whatever authority it may have under Section 6(c), the Commission is not authorized, as it has done here, to disregard the statutory purpose, painstakingly described in the legislative history, and to nullify meaningful statutory policy. The present situation with its undeniable conflicts problem rather than being "manifestly . . . not within the legislative intent" and the kind of situation "that ought not in fairness be made subject to the statute", to use the language of the draftsmen, is manifestly within the statutory intent, and fairness to the investor requires the statute's application.

In *American Trucking Association v. U. S.*, I.C.C., 364 U.S. 1, 15, 18 (1960), in reversing the Interstate Commerce Commission for failing to impose certain restrictions upon motor carrier permits that the Commission had issued, the Supreme Court observed:

"Appellees say that these safeguards are no longer needed because the independent trucking industry is no longer an 'infant industry'. This is an immaterial argument in this forum. We do not condemn the wisdom of the Commission's action. We simply say that the transportation legislation does, and that the pardoning power in this case belongs to Congress.

• • • [W]e have always recognized that the Commission has been given a wide discretion by Congress. But that discretion has limits, . . . and we conclude that those limits have been transgressed."

III. IN ANY EVENT, THE COMMISSION COULD NOT GRANT ANY EXEMPTIONS FROM SECTION 10 OF THE ACT UNLESS IT FOUND, WHICH IT DID NOT, THAT THE COMMITTEE WOULD EXERCISE THE DIRECTORIAL FUNCTIONS CONTEMPLATED BY THE ACT.

The Commission stated:

"The NASD [petitioner here] contends that the true directors of the Account will be the directors of the Bank rather than the members of the Committee, and argues that the participants will therefore be denied the right to elect the directors of the Account as required by Sections 16(a) and 18(i) of the Act. However, it is *assumed* that the Committee or its members will discharge their responsibilities as directors, or persons performing similar functions, under the securities acts or otherwise." (Emphasis added. JA 58).⁶⁷

The companion statutory rights to vote and to elect directors are satisfied, as the Commission itself has maintained, only if the investor is entitled to select the directors who have the ultimate responsibility for investment decision and management, the essence of an investment company's being.⁶⁸

⁶⁷ Section 18(i) of the Act, 54 Stat. 817, U.S.C.A., Title 15, § 80a-18(i), provides that every share of stock of an investment company shall have a vote. Section 16(a) of the Act, 54 Stat. 813, U.S.C.A., Title 15, § 80a-16(a), provides that a person may not serve as a director unless elected by the shareholders.

⁶⁸ Particularly cogent are the Commission's comments on H.R. 7482, 87th Cong., 1st Sess. to amend the District of Columbia life insurance statute as it related to issuers of variable annuity contracts, which are registered investment companies. Under the bill contract holders, instead of electing directors of the variable annuity fund, would elect a committee to make recommendations with respect to the variable annuity business, with the committee's actions subject to veto or approval by the board of directors of the sponsor insurance company. In opposing this bill before the Subcommittee

Our argument below to which the Commission alluded in the above quoted footnote passage and then by-passed was that since the Account is a department, and under control, of the Bank, and also because of the applicable banking regulations which are discussed below, the Bank will determine the Account's destiny. Therefore, the board of directors of the Bank, not the Committee, will in fact be entrusted with the directorial functions of the Account.⁶⁹ But the investor will have no voice in the election of the Bank's board, where it would be meaningful.⁷⁰

[continued from p. 33]

on Business and Commerce of the District of Columbia Committee, U.S. Senate, the Commission in a statement of August 22, 1961, declared: "

"The [Investment Company] Act contemplates that all shareholders of a management investment company will have the exclusive right, through their vote as shareholders, to [*inter alia*] . . . elect all members of the board of directors, and thereby have all investment decisions affecting portfolio securities determined by a management whose tenure in office is dependent upon shareholder vote."

The proposed special committee would not have

"the exclusive right to supervise investments decisions, as is the right and responsibility of the board of directors of a management company under the Investment Company Act . . ."

⁶⁹ The proposed prospectus states:

"Supervision of the Commingled Account is in the hands of a committee . . . The Bank is responsible for the management of the investments in the Commingled Account, . . ." (JA 15).

The prospectus, using the language of the management agreement, further states:

"The Bank will determine what securities are to be purchased or sold for the Commingled Account and will execute transactions for the Commingled Account accordingly." (JA 24).

Our position is not premised on the fact that the Bank will make portfolio selections, but rather because the Committee will as a practical matter abdicate in the investment supervisory area. Our efforts to elicit facts as to the nature of the Committee's "supervision", which is nowhere described, were rebuffed by the Commission. See note 72, *infra*.

⁷⁰ In *Cities Service Co. v. S.E.C.*, 247 F. 2d 646, 654 (C.A. 2, 1957); *cert. denied*, 355 U.S. 912 (1958) the court pointed out: "A ballot has power only when it can influence decision", and concluded that in the circumstances the vote granted security holders was "meaningless" and they were "effectively disenfranchised."

This issue raises a fundamental matter of compliance with the statute. Is the arrangement here, to use the Commission's description of the statutory policy, "consistent with the purposes of the Act to endow fund holders with the exclusive right to elect their representatives through whom their rights and interests can be pursued"?⁷¹

The Commission was not willing to decide the issue. It "assumed" compliance. It did not find, nor could it, that the Committee will be vested with the directorial duties and functions contemplated by the statute.⁷² But how can the Commission find that it is in the public interest and consistent with the protection of investors and the statutory policies, to permit a board, with a particular composition,

⁷¹ *The Prudential Insurance Company of America, Investment Company Act Release No. 3620 (January 22, 1963), p. 16.*

⁷² We filed a motion (JA 44) in which we requested the Commission to direct the Bank to supplement its application and describe the nature of the Committee's supervisory role so that the Commission could make an informed determination, which it could not do on the record before it. Our motion came after the Bank stated in its brief (p. 41) that the Account "as intended by Regulation 9" of the regulations of the Comptroller of the Currency would be operated "as an arm or department of the Bank", and in this connection called attention to Section 9.18(b)(12) of those regulations which provides, as the Bank stated, that "a national bank administering a collective investment fund shall have the *exclusive management* thereof." (Emphasis added). The Bank in that brief also stated (at p. 7) that the "actual management of the Commingled Account, including the formulation, maintenance and implementation of an investment program consistent with the investment policy stated in the prospectus will (subject to participants' approval) be carried out by the Bank pursuant to a management agreement."

But the Commission denied our motion. After stating that the application contained a description of the Account and referring to a letter of the Comptroller of the Currency (JA 47) "setting out the principal features of the proposed arrangement", the Commission concluded that "the amendment requested was not necessary for a resolution of the issues raised by the application, and that the reply briefs would afford adequate opportunity for the presentation of any relevant arguments with respect to . . . the roles of the Committee and the Bank" (JA 46-47). The arguments, which the Commission has never said were irrelevant, were accordingly briefed. But then, the Commission avoided this vexing point by in effect "assuming" there was no problem, which was facilitated by keeping the record devoid of the facts which the Bank was unwilling to reveal.

Our argument below to which the Commission alluded in the above quoted footnote passage and then by-passed was that since the Account is a department, and under control, of the Bank, and also because of the applicable banking regulations which are discussed below, the Bank will determine the Account's destiny. Therefore, the board of directors of the Bank, not the Committee, will in fact be entrusted with the directorial functions of the Account.⁶⁹ But the investor will have no voice in the election of the Bank's board, where it would be meaningful.⁷⁰

[continued from p. 33]

on Business and Commerce of the District of Columbia Committee, U.S. Senate, the Commission in a statement of August 22, 1961, declared:

"The [Investment Company] Act contemplates that all shareholders of a management investment company will have the exclusive right, through their vote as shareholders, to [*inter alia*] . . . elect all members of the board of directors, and thereby have all investment decisions affecting portfolio securities determined by a management whose tenure in office is dependent upon shareholder vote."

The proposed special committee would not have

"the exclusive right to supervise investments decisions, as is the right and responsibility of the board of directors of a management company under the Investment Company Act . . ."

⁶⁹ The proposed prospectus states:

"Supervision of the Commingled Account is in the hands of a committee . . . The Bank is responsible for the management of the investments in the Commingled Account, . . ." (JA 15).

The prospectus, using the language of the management agreement, further states:

"The Bank will determine what securities are to be purchased or sold for the Commingled Account and will execute transactions for the Commingled Account accordingly." (JA 24).

Our position is not premised on the fact that the Bank will make portfolio selections, but rather because the Committee will as a practical matter abdicate in the investment supervisory area. Our efforts to elicit facts as to the nature of the Committee's "supervision", which is nowhere described, were rebuffed by the Commission. See note 72, *infra*.

⁷⁰ In *Cities Service Co. v. S.E.C.*, 247 F. 2d 646, 654 (C.A. 2, 1957); *cert. denied*, 355 U.S. 912 (1958) the court pointed out: "A ballot has power only when it can influence decision", and concluded that in the circumstances the vote granted security holders was "meaningless" and they were "effectively disenfranchised."

This issue raises a fundamental matter of compliance with the statute. Is the arrangement here, to use the Commission's description of the statutory policy, "consistent with the purposes of the Act to endow fund holders with the exclusive right to elect their representatives through whom their rights and interests can be pursued"?⁷¹

The Commission was not willing to decide the issue. It "assumed" compliance. It did not find, nor could it, that the Committee will be vested with the directorial duties and functions contemplated by the statute.⁷² But how can the Commission find that it is in the public interest and consistent with the protection of investors and the statutory policies, to permit a board, with a particular composition,

⁷¹ *The Prudential Insurance Company of America*, Investment Company Act Release No. 3620 (January 22, 1963), p. 16.

⁷² We filed a motion (JA 44) in which we requested the Commission to direct the Bank to supplement its application and describe the nature of the Committee's supervisory role so that the Commission could make an informed determination, which it could not do on the record before it. Our motion came after the Bank stated in its brief (p. 41) that the Account "as intended by Regulation 9" of the regulations of the Comptroller of the Currency would be operated "as an arm or department of the Bank", and in this connection called attention to Section 9.18(b)(12) of those regulations which provides, as the Bank stated, that "a national bank administering a collective investment fund shall have the *exclusive management* thereof." (Emphasis added). The Bank in that brief also stated (at p. 7) that the "actual management of the Commingled Account, including the formulation, maintenance and implementation of an investment program consistent with the investment policy stated in the prospectus will (subject to participants' approval) be carried out by the Bank pursuant to a management agreement."

But the Commission denied our motion. After stating that the application contained a description of the Account and referring to a letter of the Comptroller of the Currency (JA 47) "setting out the principal features of the proposed arrangement", the Commission concluded that "the amendment requested was not necessary for a resolution of the issues raised by the application, and that the reply briefs would afford adequate opportunity for the presentation of any relevant arguments with respect to . . . the roles of the Committee and the Bank" (JA 46-47). The arguments, which the Commission has never said were irrelevant, were accordingly briefed. But then, the Commission avoided this vexing point by in effect "assuming" there was no problem, which was facilitated by keeping the record devoid of the facts which the Bank was unwilling to reveal.

unless it is satisfied that the board, however composed, will be assigned and perform the duties contemplated by the statute?

In denying our petition for rehearing, which urged that the Commission could not avoid the issue by "assumption", the Commission stated that in "assuming [in the quotation on p. 33] that the Committee . . . would discharge its responsibilities under the 'securities acts or otherwise', the Commission clearly indicated that in its opinion the banking laws or regulations did not preclude the exercise of such responsibilities" (JA 79). Even if there were this clear "indication", of which we do not even find an intimation,⁷³ the Commission was required under Section 8(b) of the Administrative Procedure Act⁷⁴ to state the basis for this conclusion. There is not even a reference, let alone a discussion, in either the Commission's Findings or its Order denying our petition for rehearing to the pertinent banking regulations set forth below, to which we had referred.

In our petition for rehearing we also pointed out that since the Commission's Findings proceeded on the hypothesis that the "Account will 'be operated under the effective control of the bank'", the Commission had acknowledged the validity of our contention. In its Order of denial the Commission concluded, again without stating

⁷³ In our petition for rehearing, we argued that even by way of assumption, the Commission had not stated that there would be compliance with the Act because the discharge of directorial responsibilities assumed by the Commission was "under the securities acts or otherwise", which a normal reading would indicate meant that the directorial performance may not necessarily satisfy the requirements of the Act, but rather some amorphous and unidentified "otherwise" (JA 76). In its order of denial, the Commission stated that "its use of the disjunctive was obviously not intended to imply that the Committee was free to avoid discharging any of the responsibilities which attach to it under the securities acts" (JA 79).

⁷⁴ Act of June 11, 1946, 60 Stat. 242, U.S.C.A., Title 5, § 1007(b) which provides in pertinent part: "All decisions . . . shall . . . include a statement of (1) findings and conclusions, as well as the reason or basis therefor, upon all the material issues of fact, law, or discretion presented on the record."

a reason, that it "saw no inconsistency between the Federal Reserve Board's view that the Account was an arm or department of the Bank for purposes of the Banking Act of 1933 and under the effective control of the Bank, and its own view that for purposes of the Investment Company Act the account was a separate entity . . ."; in this connection it pointed out that the Board recognized "that 'supervision' of the Account would be 'in the hands of a committee' elected by the investors" (JA 79).

But there is a patent inconsistency. This is not a matter of varying legal concepts under different statutes, but a question of fact. And facts do not vary with, or depend upon, the statute involved. The operative facts of control are the same under the banking laws and the Investment Company Act. If as a matter of fact the Account will and must be an arm or department of the Bank and subject to its control, i.e., responsive to its ultimate direction, as the Federal Reserve Board found and a condition with which the Commission does not want to interfere, then the Account cannot be under the control of the Committee as required by the Investment Company Act.⁷⁵

⁷⁵ The Federal Reserve Board in a letter of March 31, 1966, to the Bank's counsel, which is included in the record (Document No. 42), states:

"The Board has reviewed the matter in the light of the Commission's Order and Opinion and agrees with the conclusion apparently reached by the Commission that having 40 per cent of the members of the committee unaffiliated with the bank will not prevent the proposed account from being operated under the *effective control of the bank*. Accordingly, such a change in the proposal will not, in and of itself, require a change in the conclusion expressed in the Board's interpretation mentioned above. It should be borne in mind, however, that the Board's conclusion was based on its understanding that the account would be, *in operation*, 'nothing more than an arm or department of the bank', and any change that would tend to alter this state of affairs or remove the account from the *effective control of the bank* or make it more than simply an aspect of the bank's fiduciary function, would require further review of the matter." (Emphasis added.)

As we now show, under the Regulation 9 (12 C.F.R. 9) issued by the Comptroller of the Currency, to which the present arrangement is subject, the real management of the Account will not be the Committee, but the board of directors of the Bank, in whose selection the Account investors have no voice. As dissenting Commissioner Budge stated: "The 'single entity' interpretation is a realistic appraisal of the true nature of the Bank's proposed operation" (JA 70).

Section 9.7(a)(1) of the Comptroller's regulations provides:

"The board of directors [of a bank] is responsible for the proper exercise of fiduciary powers by the bank. All matters pertinent thereto, including the determination of policies, the investment and disposition of property held in a fiduciary capacity, and the direction and review of the actions of all officers, employees, and committees utilized by the bank in the exercise of its fiduciary powers, are the responsibility of the board." (Emphasis added).

An opinion included in the *Comptroller's Manual for Representatives in Trusts* (p. A-1) makes it clear that while a bank may assign duties to a committee, the board of the bank, whether or not it uses a committee, is the body charged with ultimate authority and responsibility. Thus, the opinion, after stating that it "is permissible to appoint any person not employed by the bank to serve as a member of a trust department committee", continues:

"Section 9.7(a)(1) places the responsibility for the supervision of fiduciary activities on the board of directors. The board may not delegate its duties but may assign their performance to directors, officers, employees, or committees, as it may choose. . . . If the board assigns functions to individuals or committees, it must take such action thereafter as is

necessary to inform itself concerning the manner in which such assignments are performed."⁷⁶

A letter from the Comptroller of the Currency (JA 47), which the Bank disclosed when it opposed our motion for additional facts,⁷⁷ supports our view. The letter first describes the Account, and states that "supervision of the Commingled Account will be in the hands of a committee" and that "the bank will be responsible for the management of the investments in the Commingled Account." The letter then concludes in pertinent part:

"As contemplated, the Commingled Account does not comply with certain provisions of Section 9.18(b) [which has some 22 provisions] * * * Accordingly, . . . the arrangement . . . is hereby approved so long as the rules and regulations of the Comptroller of Currency applicable to collective investment, specifically the provisions of Section 9.18(b), except as provided for in the foregoing arrangement, are complied with . . ."

Thus, except for the undesignated exemptions from Section 9.18(b), the arrangement was "approved so long as the rules and regulations of the Comptroller of Currency applicable to collective investment . . . are complied with." The Bank, therefore, is subject to Section 9.7(a)(1), which vests the board of a bank, whether or not it appoints a committee, with ultimate responsibility and authority. There is not even an intimation in the letter that the Bank

⁷⁶ In his remarks explaining the revision of Regulation 9, the Comptroller stated:

"In the area of management supervision our primary emphasis has been on the *responsibility of the board of directors for the proper supervision of trust funds* . . . [E]ach individual board of directors has been left to carry out its responsibilities in such manner as it may deem most practical . . . [A]ny existing system or other organization of the trust department is acceptable, as long as it is clear that the board of directors is fully aware of its responsibilities and is carrying them out. The inquiry will be to substance and not to form." (Emphasis added). Government Operations Committee Hearings (note 21, *supra*), p. 68.

⁷⁷ See note 72, *supra*.

is exempt from Section 9.7(a)(1). Nor is there an intimation that the Committee here is not of the type embraced by and subject to Section 9.7(a)(1). The Comptroller's opinion, as pointed out above, specifically authorizes the use of non-bank personnel for a trust department committee. Moreover, the reasonable inference is that Section 9.18(b)(12), which provides that a bank shall have the "exclusive management" of a collective investment fund, is not one of the unspecified exemptions from Section 9.18(b) which the Bank enjoys.⁷⁸ Responsibility is ordinarily an incident of authority. If the Bank is responsible for the Fund, it is unlikely that the Bank would be relieved of the "exclusive management" function, particularly since the Account must be under the effective control of the Bank.

Before the Commission may make the findings required by Section 6(c) it must come to grips with the basic problem of whether the Committee here is a board of directors with the responsibilities contemplated by the statute. It cannot avoid this issue.

CONCLUSION

For the foregoing reasons, the orders of the Commission should be reversed.

Respectfully submitted,

MARC A. WHITE

General Counsel

*National Association of
Securities Dealers, Inc.*

888 17th Street, N. W.

Washington, D. C. 20006

JOSEPH B. LEVIN

Brown Lund & Levin

1625 Eye Street, N. W.

Washington, D. C. 20006

August 1966

⁷⁸ This was also the Bank's view (see note 72, *supra*), which it has since sought to disclaim.

APPENDIX**Provisions of Investment Company Act of 1940****1. Section 6 (c)—**

(c) The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.

2. Sections 10 (a), (b), (c), (d) and (f)—

(a) After one year from the effective date of this title, no registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are investment advisers of, affiliated persons of an investment adviser of, or officers or employees of, such registered company.

(b) After one year from the effective date of this title, no registered investment company shall—

(1) employ as regular broker any director, officer, or employee of such registered company, or any person of which any such director, officer, or employee is an affiliated person, unless a majority of the board of directors of such registered company shall be persons who are not such brokers or affiliated persons of any of such brokers;

(2) use as a principal underwriter of securities issued by it any director, officer, or employee of such registered company or any person of which any such director, officer, or employee is an affiliated person, unless a majority of the board of directors of such registered company shall be persons who are not

such principal underwriters or affiliated persons of any such principal underwriters; or

(3) have as director, officer, or employee any investment banker, or any affiliated person of an investment banker, unless a majority of the board of directors of such registered company shall be persons who are not investment bankers or affiliated persons of any investment banker. For the purposes of this paragraph, a person shall not be deemed an affiliated person of an investment banker solely by reason of the fact that he is an affiliated person of a company of the character described in section 12 (d) (3) (A) and (B).

(c) After the effective date of this title, no registered investment company shall have a majority of its board of directors consisting of persons who are officers or directors of any one bank: *Provided*, That, if on March 15, 1940, any registered investment company shall have had a majority of its directors consisting of persons who are directors, officers, or employees of any one bank, such registered company may continue to have the same percentage of its board of directors consisting of persons who are directors, officers, or employees of such bank.

(d) Notwithstanding subsection (a) and subsection (b) (2), a registered investment company may have a board of directors all the members of which, except one, are affiliated persons of the investment adviser of such company, or are officers or employees of such company, if—

(1) such investment company is an open-end company;

(2) such investment adviser is registered under title II of this Act and such investment adviser is engaged principally in the business of rendering investment supervisory services as defined in title II;

(3) no sales load is charged on securities issued by such investment company;

(4) any premium over net asset value charged by such company upon the issuance of any such security, plus any discount from net asset value charged on redemption thereof, shall not in the aggregate exceed 2 per centum;

(5) no sales or promotion expenses are incurred by such registered company; but expenses incurred in complying with laws regulating the issue or sale of securities shall not be deemed sales or promotion expenses;

(6) such investment adviser is the only investment adviser to such investment company, and such investment adviser does not receive a management fee exceeding 1 per centum per annum of the value of such company's net assets averaged over the year or taken as of a definite date or dates within the year;

(7) all executive salaries and executive expenses and office rent of such investment company are paid by such investment adviser; and

(8) such investment company has only one class of stock outstanding, each share of which has equal voting rights with every other share.

* * *

(f) No registered investment company shall knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security (except a security of which such company is the issuer) a principal underwriter of which is an officer, director, member of an advisory board, investment adviser, or employee of such registered company, or is a person (other than a company of the character described in section 12 (d) (3) (A) and (B)) of which any such officer, director, member of an advisory board, investment adviser, or employee is an affiliated person, unless in acquiring such security such registered company is itself acting as a principal under-

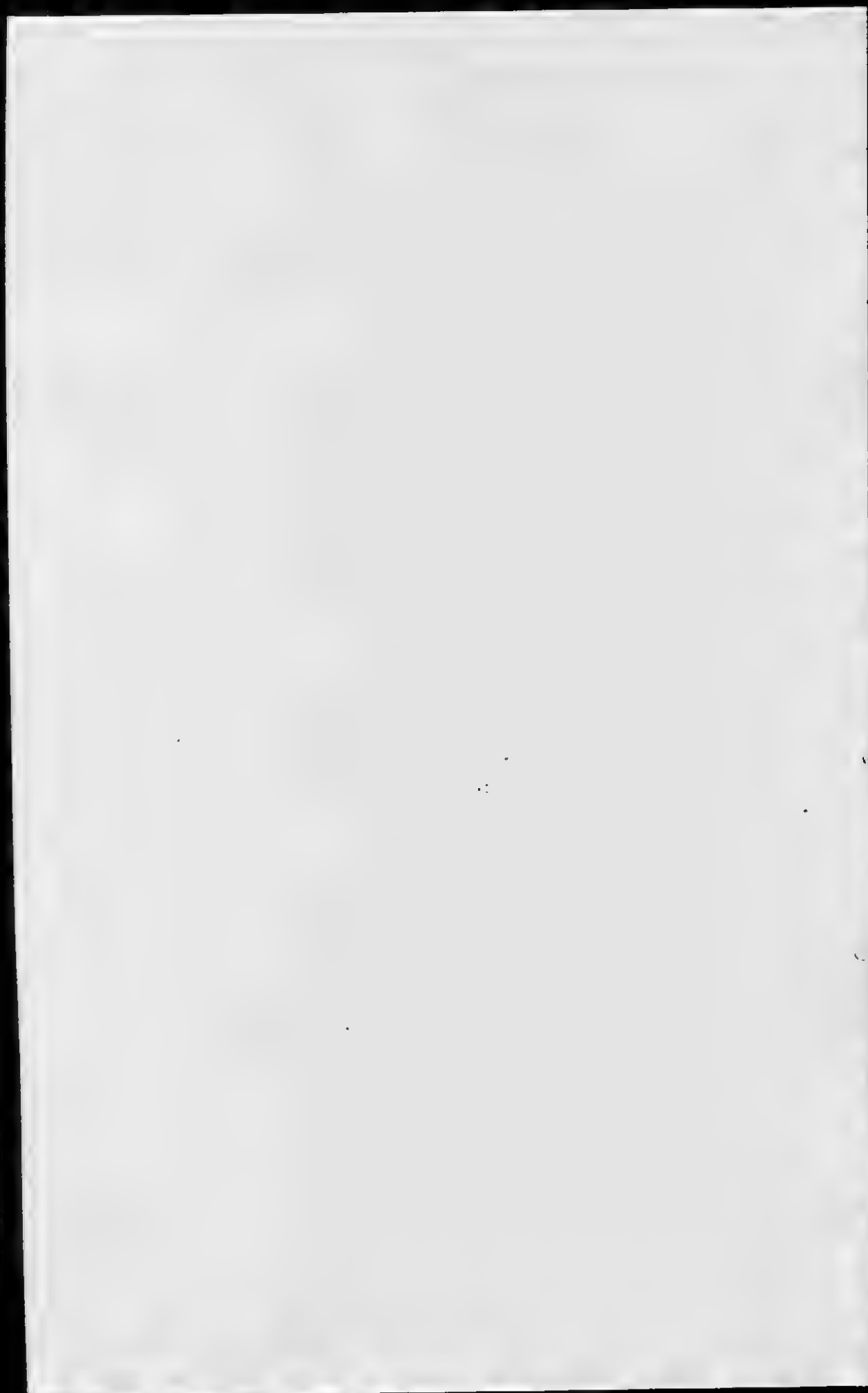
writer for the issuer. The Commission, by rules and regulations upon its own motion or by order upon application, may conditionally or unconditionally exempt any transaction or classes of transactions from any of the provisions of this subsection, if and to the extent that such exemption is consistent with the protection of investors.

3. Section 16 (a), in pertinent part—

(a) No person shall serve as a director of a registered investment company unless elected to that office by the holders of the outstanding voting securities of such company, at an annual or a special meeting duly called for that purpose; except that vacancies occurring between such meetings may be filled in any otherwise legal manner if immediately after filling any such vacancy at least two-thirds of the directors then holding office shall have been elected to such office by the holders of the outstanding voting securities of the company at such an annual or special meeting. In the event that at any time less than a majority of the directors of such company holding office at that time were so elected by the holders of the outstanding voting securities, the board of directors or proper officer of such company shall forthwith cause to be held as promptly as possible and in any event within sixty days a meeting of such holders for the purpose of electing directors to fill any existing vacancies in the board of directors unless the Commission shall by order extend such period. The foregoing provisions of this subsection shall not apply to members of an advisory board.

4. Section 18 (i), in pertinent part—

(i) Except as provided in subsection (a) of this section, or as otherwise required by law, every share of stock hereafter issued by a registered management company (except a common-law trust of the character described in section 16 (b)) shall be a voting stock and have equal voting rights with every other outstanding voting stock:



BRIEF FOR RESPONDENT

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 20164

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

FIRST NATIONAL CITY BANK, INTERVENOR

ON PETITION TO REVIEW ORDERS OF THE SECURITIES AND
EXCHANGE COMMISSION
United States Court of Appeals
for the District of Columbia Circuit

FILED - NOV 2 1966 -

PHILIP A. LOOMIS, JR.
General Counsel

DAVID FERBER,
Solicitor

Nathan J. Paulson
CLERK

LEONARD S. MACHTINGER,
Attorney,
Securities and Exchange Commission,
Washington, D.C. 20549

Of Counsel:

JOHN A. DUDLEY,
Assistant Director

ROBERT E. OLSON,
Special Counsel

Division of Corporate Regulation,
Securities and Exchange Commission

STATEMENT OF QUESTIONS PRESENTED

In the opinion of the Securities and Exchange Commission, respondent herein, the questions presented are:

1. Whether the Commission acted within the bounds of its discretionary authority under Section 6(c) of the Investment Company Act of 1940 in exempting a bank collective investment fund from certain provisions of Section 10 of that Act, which, in effect, would have required a majority of the board of directors of the fund to be composed of persons who are not officers or directors of the bank, with the result that at least 40 per cent of the board members will at all times be persons "unaffiliated" with the bank.

2. Whether the Commission was entitled to assume that the provisions of the Investment Company Act of 1940 would be complied with by the directors of the bank collective investment fund, in the absence of any showing of the contrary.

□

INDEX

	Page
Jurisdictional statement.....	1
Statutes involved.....	3
Counterstatement of the case.....	8
A. Background.....	8
B. The Commission's Opinion.....	11
Summary of argument.....	16
Argument.....	17
I. The result reached by the Commission was within the bounds of its discretionary authority under section 6(c) of the Investment Company Act of 1940.....	17
A. The Commission properly found that the Account is not the kind of investment entity intended to be prohibited by Section 10(c).....	20
B. The Commission's conclusion that there are substan- tial safeguards against the conflicts of interest which could arise as a result of the intervenor's commer- cial banking activities was warranted by the facts.....	25
II. In the absence of any showing to the contrary, the Commis- sion was entitled to assume that the directors of the Account would comply with the provisions of the Investment Com- pany Act of 1940.....	27
Conclusion.....	32

CITATIONS

Cases:

<i>American Participations, Inc.</i> , 10 S.E.C. 431 (1941).....	17
<i>The Atlantic Coast Line Company</i> , 11 S.E.C. 661 (1942).....	21
<i>Brown v. Bullock</i> , 294 F. 2d 415 (C.A. 2, 1961).....	30, 32
<i>Prudential Insurance Company of America</i> , Investment Company Act Release No. 3620 (January 22, 1963), <i>affirmed</i> , 326 F. 2d 383 (C.A. 3, 1964), <i>certiorari denied</i> , 377 U.S. 953.....	8, 19, 20
<i>Securities and Exchange Commission v. Variable Annuity Life In- surance Company of America</i> , 359 U.S. 65 (1959).....	8
<i>Transit Investment Corporation</i> , 28 S.E.C. 10 (1948).....	17

Statutes and Rules:

Administrative Procedure Act, Section 8(b), Act of June 11, 1946, c. 19, 60 Stat. 242, U.S.C.A., Title 5, § 1007(b).....	29
Banking Act of 1933, Section 32, Act of June 16, 1933, c. 89, 48 Stat. 194, as amended, U.S.C.A., Title 12, § 78.....	13, 23

IV

Statutes and Rules—Continued

	Page
Investment Advisers Act of 1940, Act of August 22, 1940, c. 686, 54 Stat. 847, as amended, <i>et seq.</i> , U.S.C.A., Title 15, § 80b-1, <i>et seq.</i>	
Section 202(a) (11) and (13), 54 Stat. 847, as amended, U.S.C.A., Title 15, § 80b-2(a) (11) and (13)-----	14
Section 203(b) (2), 54 Stat. 850, as amended, U.S.C.A., Title 15, § 80b-3(b) (2)-----	14
Investment Company Act of 1940, Act of August 22, 1940, c. 686, 54 Stat. 789, as amended, <i>et seq.</i> , U.S.C.A., Title 15, § 80a-1, <i>et seq.</i> -----	1
Section 1(b), 54 Stat. 789, U.S.C.A., Title 15, § 80a-1(b)-----	4
Section 2(a) (19), 54 Stat. 790, as amended, U.S.C.A., Title 15, § 80a-2(a) (19)-----	28
Section 2(a) (39), 54 Stat. 790, as amended, U.S.C.A., Title 15, § 80a-2(a) (39)-----	31
Section 6(c), 54 Stat. 800, as amended, U.S.C.A., Title 15, § 80a-6(c)-----	2, 6, 7, 16, 17, 21, 24
Section 7, 54 Stat. 802, U.S.C.A., Title 15, § 80a-7-----	3
Section 8, 54 Stat. 803, as amended, U.S.C.A., Title 15, § 80a-8-----	3
Section 9(a), 54 Stat. 805, U.S.C.A., Title 15, § 80a-9(a)-----	19
Section 10, 54 Stat. 806, U.S.C.A., Title 15, § 80a-10-----	5, 24, 26
Section 10(a), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(a)-----	6, 7, 14, 15, 26
Section 10(b) (2), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(b) (2)-----	6, 7, 15, 16
Section 10(b) (3), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(b) (3)-----	6, 13, 15, 25, 27
Section 10(c), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(c)-----	6, 13, 14, 15, 16, 20, 23, 24, 25
Section 10(d), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(d)-----	7, 14, 15
Section 10(d) (2), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(d) (2)-----	13, 14
Section 10(d) (3), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(d) (3)-----	7
Section 12(d) (3), 54 Stat. 808, U.S.C.A., Title 15, § 80a-12(d) (3)-----	23
Section 13(a), 54 Stat. 811, U.S.C.A., Title 15, § 80a-13(a)-----	30
Section 15(a), 54 Stat. 812, U.S.C.A., Title 15, § 80a-15(a)-----	5, 30
Section 15(a) (3), 54 Stat. 812, U.S.C.A., Title 15, § 80a-15(a) (3)-----	5, 31
Section 15(c), 54 Stat. 812, U.S.C.A., Title 15, § 80a-15(c)-----	7, 10, 31
Section 16(a), 54 Stat. 813, U.S.C.A., Title 15, § 80a-16(a)-----	5, 30
Section 17, 54 Stat. 815, U.S.C.A., Title 15, § 80a-17-----	5
Section 20(a), 54 Stat. 822, U.S.C.A., Title 15, § 80a-20(a)-----	5
Section 22, 54 Stat. 823, U.S.C.A., Title 15, § 80a-22-----	3
Section 30, 54 Stat. 836, U.S.C.A., Title 15, § 80a-29-----	31
Section 30(a), 54 Stat. 836, U.S.C.A., Title 15, § 80a-29(a)-----	5
Section 30(b), 54 Stat. 836, U.S.C.A., Title 15, § 80a-29(b)-----	5

Statutes and Rules—Continued

Investment Company Act of 1940—Continued

	Page
Section 30(d), 54 Stat. 836, U.S.C.A., Title 15, § 80a-29(d).....	5
Section 32(a), 54 Stat. 838, U.S.C.A., Title 15, § 80a-31(a).....	7, 30
Section 32(a)(2), 54 Stat. 838, U.S.C.A., Title 15, § 80a-31(a)(2).....	5
Section 36, 54 Stat. 841, U.S.C.A., Title 15, § 80a-35.....	5, 31
Section 42, 54 Stat. 842, U.S.C.A., Title 15, § 80a-41.....	5
Section 43(a), 54 Stat. 844, as amended, U.S.C.A., Title 15, § 80a-42(a).....	2
Regulation 9 of the Comptroller of the Currency, 12 CFR 9.....	13, 26
Section 9.7(a)(1), 12 CFR 9.7(a)(1).....	31, 32
Section 9.18(c)(5), 12 CFR 9.18(c)(5).....	13, 29
Rule 2a-3, under the Investment Company Act of 1940, 17 CFR 270.2a-3.....	23
Securities Act of 1933, Act of May 27, 1933, c. 38, 48 Stat. 74, as amended, <i>et seq.</i> , U.S.C.A., Title 15, § 77a, <i>et seq.</i>	
Section 5, 48 Stat. 77, as amended, U.S.C.A., Title 15, § 77a.....	4
Section 6, 48 Stat. 78, U.S.C.A., Title 15, § 77f.....	4
Section 10, 48 Stat. 81, as amended, U.S.C.A., Title 15, § 77j.....	4

Miscellaneous:

Federal Reserve Board Decision, 12 CFR 218.111.....	29
Hearings on Common Trust Funds—Overlapping Responsibility and Conflict in Regulation Before a Subcommittee of the House Committee on Government Operations, 88th Cong., 1st Sess. (1963).....	25
Hearings on H.R. 10065 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 76th Cong., 3d Sess. (1940).....	6, 10
Hearings on S. 2704 Before a Subcommittee of the Senate Committee on Banking and Currency, 89th Cong., 2d Sess. (1966).....	19
Hearings Pursuant to S. Res. 71 Before a Subcommittee of the Senate Committee on Banking and Currency, 71st Cong., 3d Sess. (1931).....	22
H.R. Rep. No. 429, 88th Cong., 1st Sess. (1963).....	19
H.R. Rep. No. 2639, 76th Cong., 3d Sess. (1940).....	4
Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission:	
Pt. 1, H.R. Doc. No. 707, 75th Cong., 3d Sess. (1938).....	22
Pt. 2, H.R. Doc. No. 70, 76th Cong., 1st Sess. (1939).....	9
S. 2704, 89th Cong., 2d Sess. (1966).....	19
Stock Exchange Practices, Report of the Committee on Banking and Currency, S. Rep. No. 1455, 73d Cong., 2d Sess. (1934).....	23



United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 20164

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION, RESPONDENT
FIRST NATIONAL CITY BANK, INTERVENOR

ON PETITION TO REVIEW ORDERS OF THE SECURITIES AND
EXCHANGE COMMISSION

BRIEF FOR RESPONDENT

JURISDICTIONAL STATEMENT

Petitioner, the National Association of Securities Dealers, Inc. ("NASD"), seeks to review orders entered by the Securities and Exchange Commission under the Investment Company Act of 1940, Act of August 22, 1940, c. 686, 54 Stat. 789, as amended, U.S.C.A., Title 15, § 80a-1, *et seq.*, granting certain exemptions from the Act to the Commingled Investment Account ("Account"), an investment fund established by the First National City Bank of New York City ("Bank").¹ Pe-

¹ The orders under review are an order of March 9, 1966, granting in part and denying in part the Bank's application for exemption (JA 72), an order dated March 14, 1966, correcting the order of March 9, 1966, (JA 73), and an order of April 6, 1966, denying the NASD's petition for rehearing (JA 77). "JA —" refers to pages in the Joint Appendix.

itioner invokes the jurisdiction of this Court under Section 43(a) of the Investment Company Act,² which provides that "[a]ny person or party aggrieved by an order issued by the Commission under this title may obtain a review of such order . . . in the United States Court of Appeals for the District of Columbia. . . ."

The proceeding before the Commission was initiated by the Bank's filing an application (JA 2-36) under Section 6(c) of the Investment Company Act,³ which provides that "[t]he Commission . . . by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions" of the Act "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of" the Act. The exemptions granted by the Commission permit a committee of five persons ("Committee"), which is to supervise the operation of the Account and perform functions similar to that of a board of directors, to include three members who are officers or directors of the Bank. In the absence of the Commission's exemptive order, a majority of the members of the Committee would have had to be persons who are not officers or directors of the Bank.

In the proceeding before the Commission, the NASD and other persons who objected to the application filed briefs and presented oral arguments (JA 54). No evidentiary hearing was requested (JA 54). The Commission permitted the NASD to participate in the proceeding, without passing upon the question raised by the Bank as to the NASD's standing (JA 54, n. 3).

² 54 Stat. 844, as amended, U.S.C.A., Title 15, § 80a-42(a).

³ 54 Stat. 800, as amended, U.S.C.A., Title 15, § 80a-3(c).

Since this case presents important issues of statutory interpretation and policy under the Investment Company Act, the Commission welcomes the opportunity to have its decision reviewed by an appellate court and, therefore, does not challenge the standing of the NASD to seek review of the Commission's orders. This is not to say that the Commission believes that every competitor, investor, or other person who contends that he will suffer some indirect economic injury as a result of a Commission order has standing to seek review of that order. Any such broad proposition would seriously obstruct and delay the administration of the federal securities laws. The situation of the NASD, however, is unique in that, as a registered national securities association to whom Congress has delegated major self-regulatory responsibilities in the securities markets, it has significant functions and responsibilities in the administration and enforcement of the Investment Company Act.⁴ The Commission, therefore, interposes no objection to review at the instance of the NASD, but respectfully suggests that if the Court concludes that the NASD has standing, this decision should be based primarily upon the NASD's statutory responsibilities rather than upon the rather remote injury to the members of the NASD attributable to the competition of the Bank.

STATUTES INVOLVED

The Account established by the Bank is registered as an investment company under the Investment Company Act of 1940,⁵ and the securities issued by the Account are registered under the Securities Act of

⁴ Section 22, 54 Stat. 823, U.S.C.A., Title 15, § 80a-22.

⁵ Sections 7 and 8 of the Investment Company Act, 54 Stat. 802 and 803, as amended, U.S.C.A., Title 15, §§ 80a-7, 8.

1933.* The Securities Act, which requires full disclosure regarding securities being offered for sale, as applied here, requires that potential investors receive a prospectus[†] containing pertinent information regarding the management of the Account, its investment objectives, policies and restrictions, and the rights of the participants in the Account.

The pertinent provisions of the Investment Company Act are set forth in the Appendix to the NASD's brief. Various practices prevalent in the investment company industry, which were not curbed by the full disclosure provisions of the Securities Act of 1933 and which Congress found adverse to the national public interest and the interests of investors, were sought to be eliminated by the Investment Company Act of 1940.* Among the provisions of the Act adopted by the Congress to curb such practices are requirements designed to encourage investors' knowledge of and participation in the affairs of investment companies, to require approval by investors of fundamental changes in investment companies' business or character, and to foster integrity in the management of the companies.

In accordance with the requirements of the Investment Company Act, participants in the Account will

* Sections 5 and 6 of 1933 Act, Act of May 27, 1933, c. 38, 48 Stat. 77, as amended, and 48 Stat. 78, U.S.C.A., Title 15, § 77e and 77f. The securities issued by the Account are designated participations and investors are referred to as participants.

[†] *Ibid.* and Section 10 of the 1933 Act, 48 Stat. 81, as amended, U.S.C.A., Title 15, § 77j. A preliminary draft of the prospectus of the Account appears at JA 15-29.

* H.R. Rep. No. 2639, 76th Cong., 3d Sess. 10 (1940). See Section 1(b) of 1940 Act, 54 Stat. 789, U.S.C.A., Title 15, § 80a-1(b).

elect their directors,⁹ approve the advisory contract between the Account and the Bank, the Account's investment adviser,¹⁰ have the power to terminate that contract on 60 days notice,¹¹ and ratify the selection of auditors.¹² The members of the Committee and the Bank, as managers of the participants' monies, are subject to prohibitions against self-dealing,¹³ and the Commission can bring injunctive actions against them for their failure to perform their duties.¹⁴ Participants receive periodic reports and proxy statements so that they will be placed in a position to determine whether their investments have been handled properly.¹⁵ Additional reports must be filed with the Commission for public inspection.¹⁶

Among the requirements of the Investment Company Act intended to foster integrity of management are those contained in Section 10 of the Act,¹⁷ which is directly involved in this case. In view of the fact that the managers receive financial benefits from their positions as officers, employees, investment advisers, or principal underwriters of the investment company, the Investment Company Act provides that certain

⁹ Section 16(a), 54 Stat. 818, U.S.C.A., Title 15, § 80a-16(a).

¹⁰ Section 15(a), 54 Stat. 812, U.S.C.A., Title 15, § 80a-15(a).

¹¹ Section 15(a)(3), 54 Stat. 812, U.S.C.A., Title 15, § 80a-15(a)(3).

¹² Section 32(a)(2), 54 Stat. 838, U.S.C.A., Title 15, § 80a-31(a)(2).

¹³ Section 17, 54 Stat. 815, U.S.C.A., Title 15, § 80a-17.

¹⁴ Section 36, 54 Stat. 841, U.S.C.A., Title 15, § 80a-35, and Section 42, 54 Stat. 842, U.S.C.A., Title 15, § 80a-41.

¹⁵ Section 30(d), 54 Stat. 836, U.S.C.A., Title 15, § 80a-29(d), and Section 20(a), 54 Stat. 822, U.S.C.A., Title 15, § 80a-20(a).

¹⁶ Sections 30(a) and 30(b), 54 Stat. 836, U.S.C.A., Title 15, §§ 80a-29(a) and (b).

¹⁷ 54 Stat. 806, U.S.C.A., Title 15, § 80a-10.

members of an investment company's board of directors be unaffiliated with the managers.¹² The Section also provides that a majority of a board may not be affiliated with investment bankers or with any one commercial bank. The number of unaffiliated members of the board required by Section 10 varies; it may be one member, 40%, or a majority of the board, depending upon circumstances spelled out in the section.

Thus, if there were no exemption granted by the Commission under Section 6(c), Section 10(b)(3), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(b)(3), would preclude an investment company from having a majority of its board comprised of persons who are officers, directors, or employees of investment bankers; Section 10(c), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(c), would preclude a majority of the board of directors from consisting of persons who are officers or directors of a single bank; and Section 10(b)(2), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(b)(2), would

¹² In explaining Section 10(a), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(a), David Schenker, a Commission spokesman for the bill which became the Act, stated as follows:

"In essence, what does that section provide? The section provides that if you are the manager or investment adviser of an investment company or investment trust, then 40 percent of the board of directors have to be independent of you.

"Now, why do we make that provision? You can see that the manager has a pecuniary interest in the method of running the trust, because his management fees may depend upon the performance of the trust. In order to furnish an independent check upon the management, the provision is made that at least 40 percent of the board must be independent of the management, officers and employees. I think that is one of the most salutary provisions in this bill." *Hearings on H.R. 10065 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 109 (1940).*

preclude a majority of the board of directors from, in effect, being officers or directors of a principal underwriter. Section 10(a) precludes more than 60% of the directors from being persons who are officers or directors of the investment adviser. Notwithstanding the provisions of Sections 10(a) and 10(b)(2), Section 10(d), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(d), relating to certain types of "no load funds,"¹⁹ provides that, if certain conditions are met, all but one of the directors may be officers or directors of the investment adviser.

In addition to the overall "watchdog" purpose served by the unaffiliated directors in the affairs of the investment company, certain specific functions are assigned to the unaffiliated directors. A majority of the unaffiliated directors must (i) select the independent public accountant who certifies the financial statements of the investment company²⁰ and, perhaps most importantly, (ii) approve renewal of the investment advisory contract where the board does not submit the contract for a vote of shareholders.²¹

Section 6(c) of the Investment Company Act, referred to, *supra*, at page 2, grants the Commission broad exemptive authority. It provides:

"The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions

¹⁹ This is a term generally used to describe a fund where "no sales load is charged on securities issued by . . . [an] investment company," Section 10(d)(3), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(d)(3).

²⁰ Section 32(a), 54 Stat. 838, U.S.C.A., Title 15, § 80a-31(a).

²¹ Section 15(c), 54 Stat. 812, U.S.C.A., Title 15, § 80a-15(c).

of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

COUNTERSTATEMENT OF THE CASE

A. Background

Some discussion of the nature of investment companies and the structural pattern prevailing in the investment company industry may contribute to an understanding of the issues in this case and of the Commission's decision in its statutory and industry context.

Broadly speaking, an investment company is any arrangement by which a number of persons invest funds in a "company" that is itself engaged in investing in securities. Such a company may be a corporation, a partnership, a trust, a fund or any organized group of persons whether incorporated or not.²² It is by reason of this broad definition that the Account is, as the NASD agrees, an investment company requiring registration under the Act, notwithstanding the fact that it is for other purposes not a separate legal entity, and the Comptroller of the Currency and the Federal Reserve Board view it for purposes of the federal banking laws as a part of the Bank.²³

²² These concepts are discussed and developed at considerable length by the Commission and by the Court of Appeals for the Third Circuit in *Prudential Insurance Company of America, Investment Company Act* Release No. 3620 (January 22, 1963), affirmed, 326 F. 2d 383 (C.A. 3, 1964), certiorari denied, 377 U.S. 953. See also *Securities and Exchange Commission v. Variable Annuity Life Insurance Company of America*, 359 U.S. 65 (1959).

²³ There are various types of investment companies which are separately classified in the Act and which operate in quite different

A typical open-end investment company or mutual fund²³ has rather limited independent existence apart from its investment adviser or sponsor. Not only the function of providing investment advice but the function of management itself is largely delegated to an external investment adviser. This structure seems to stem from the fact that many of the early open-end investment companies were organized by investment counselors²⁴ who viewed these companies as simply a medium by which they might serve smaller clients and not as business enterprises capable of existing independently of their sponsors. Thus, in most mutual funds the adviser does more than give advice. It selects the fund's portfolio and operates or supervises other aspects of its business. Although the fund itself has a board of directors, and one or more executive officers or trustees, a substantial portion, frequently a majority, of the directors and all or virtually all of its officers, will normally be associated with or employed by its adviser. In most cases all of the compensation that such persons receive for their services to the fund is paid to them by the adviser and not by the fund. Most advisers also supply the fund that they manage with office space and clerical and accounting personnel necessary to carry on the fund's

ways. The Account, like a mutual fund, falls into the statutory classification of an open-end management company. Such an investment company is usually continuously issuing shares which are redeemable upon presentation by the shareholder based upon his proportionate share of the company's current net assets or the cash equivalent. This redeemability feature distinguishes the mutual fund from the closed-end investment company. As of June 30, 1966, open-end investment companies reported net assets of approximately \$38 billion and closed-end investment companies reported net assets of approximately \$6.6 billion.

²⁴ *Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pt. 2, H.R. Doc. No. 70, 76th Cong., 1st Sess. 57, 59 (1939).*

business. In most, if not in all, cases such services are paid for by the basic advisory fee.

The framers of the Investment Company Act accepted this basic structure and, rather than seeking to require that all investment companies function as independent business enterprises, merely sought to interpose certain checks upon the dominance of advisers without divesting them of control.²⁸ Thus, Section 16(a) of the Act, generally speaking, requires that directors of an investment company be elected by the holders of voting securities of the company, and Section 10(a) provides that not more than 60 percent of the directors of an investment company may be affiliated with the investment adviser. The Act imposes upon the directors certain statutory functions described in more detail, *infra*, at page 31, and Section 15(c), as we have seen (*supra*, at page 7), requires that investment advisory contracts be approved by a majority of those directors who are not affiliated with the investment adviser or, alternatively, by a vote of the majority of the outstanding voting securities of the company. The Commission did not grant exemption from any of these basic requirements of the Act. In evaluating the Commission's decision it must be borne in mind that the Act does not contemplate or require that investment companies be wholly independent of their advisers; the typical industry pattern both before and after the enactment of the statute was, and is, that open-end investment companies may be and usually are controlled and managed by their investment advisers subject to various specific statutory safeguards designed to give the investors themselves a voice in the management of the

²⁸ *Hearings on H.R. 10065 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 109-110 (1940).*

company and to provide independent directors who will act as a check upon the managers.

B. The Commission's opinion

In its findings and opinion (JA 52-68) the Commission describes the Bank's application, discusses certain background facts and sets forth its reasons for granting some but not all of the relief sought.

In its application the Bank represented that it proposed to establish and operate a collective investment fund which was to be known as the Commingled Investment Account (JA 54). For purposes of the Investment Company Act the Account would be a legal entity distinct from the Bank and would be registered under that Act as a diversified, open-end management investment company (JA 54).

It was proposed that the Account would accept investments of \$10,000 or more pursuant to agreements signed by persons ("participants") authorizing the Bank to place their monies in the Account (JA 55). Monies contributed by participants would be collectively invested in a pool of securities, principally common stocks and securities convertible into common stocks (JA 55). There would be no sales charge imposed on monies contributed by participants (JA 55); nor would there be any fee upon the redemption of a participant's interest in the Account (JA 55).

The Bank proposed to serve as investment adviser to the Account pursuant to a written contract between the Committee on behalf of the Account and the Bank (JA 55; 29-35). Under this contract, or management agreement, the Bank is to determine what securities are to be purchased and sold and is to execute all transactions (JA 55-56). The management agreement also provides that the Bank is to act as custodian for the assets of the Account (JA 55) and

is to furnish all administrative and clerical services, the office space and other facilities required by the Account, which will have no officers or employees (JA 56). In return for these services, the Bank is to receive a fee equal, on an annual basis, to $\frac{1}{2}$ of 1% of the average net asset value of the Account (JA 56).

The participations in the Account will not be distributed or underwritten by broker-dealers (JA 55). The Commission, however, regards the Bank, which makes participations in the Account available, to be a statutory underwriter of the participations for purposes of the securities acts (JA 73-74). The Bank is also regarded under the Investment Company Act as the principal underwriter for the Account (JA 74).

The Bank proposed that the supervision of the operations of the Account would be vested in a Committee, which would act as a board of directors, the members of the Committee to be elected by the participants in the Account (JA 55). Under the management agreement, all transactions of purchase or sale of securities on behalf of the Account are to be promptly reported to the Committee by the Bank (JA 32). The Bank also is required to transmit to the Committee all notices, proxy forms and proxy statements and other requests and announcements furnished to the Bank regarding the securities in the portfolio of the Account (JA 33). The Bank is to execute and deliver the proxies and other authorizations as directed by the Committee (JA 33).

The Commission noted (JA 54-55) that the Account would be operated as a collective investment fund under applicable regulations of the Comptroller of the Currency. The Bank had for many years managed individual accounts of its customers in so-called managing agency accounts (JA 56). The smallest account which the Bank represented it could econom-

ically manage on an individual basis was \$200,000 (JA 56). The stated purpose of the Account was to make available the Bank's investment-managing services to the smaller investor through the mechanism of investing and managing the smaller amounts of monies collectively (JA 56). Prior to 1963, national banks had been prohibited from commingling managing agency accounts (JA 56). In 1963, the Comptroller revised Regulation 9 (12 CFR 9) to permit collective investment of funds received in managing agency accounts by the Bank as a fiduciary if approved by the Comptroller (JA 56; 12 CFR 9.18 (c)(5)).

The Commission took cognizance of the fact that the banking authorities regarded the Account to be consistent with the banking laws. It noted that the Comptroller had approved the Bank's arrangement, that the Board of Governors of the Federal Reserve System had ruled that the arrangement would not violate Section 32 of the Banking Act of 1933, Act of June 16, 1933, c. 89, 49 Stat. 194, as amended, U.S.C.A., Title 12, § 78, (JA 56-57) and that the Federal Deposit Insurance Corporation supported the Bank's application (JA 57).

The Bank sought exemptions principally from three subparagraphs of Section 10 of the Investment Company Act: subparagraphs (b)(3), (c) and (d)(2)* (JA 58). The relief sought, if granted, would have authorized all but one of the members of the Committee, the board of directors of the Account, to be officers or directors of the Bank. In the absence of exemption Section 10(b)(3) would have precluded the Account from having a majority of its board comprised of persons who are officers, directors or em-

* 54 Stat. 806, U.S.C.A., Title 15, §§ 80a-10(b)(3), 10(c), and 10(d)(2).

ployees of the Bank, since the Bank is an investment banker in that it participates in syndicates underwriting United States Government and municipal obligations (JA 64). Similarly, in the absence of an exemption Section 10(c) would also have precluded a majority of the Committee from consisting of persons who are officers or directors of the Bank. An exemption was also sought by the Bank from a condition of Section 10(d), which section under certain circumstances provides that an investment company which charges "no sales load on securities issued" may have only one director unaffiliated with the investment adviser instead of at least 40% unaffiliated, as otherwise required by Section 10(a) of the Act; the condition sought to be waived by the Bank was that contained in subdivision (2) of Section 10(d) that the investment adviser be registered under the Investment Advisers Act and engaged principally in the business of rendering investment supervisory services, a condition that the Bank could not meet (JA 66).²⁷

²⁷ The Bank could not meet this condition because, while the rendering of investment supervisory services is an important aspect of the Bank's business, the Bank stated that it may not be "engaged principally" in the business of rendering such services and, in addition, by definition, a bank is not an investment adviser under the Investment Advisers Act of 1940 (JA 66). The term "investment supervisory services" is defined in Section 202(a)(13) of the Investment Advisers Act of 1940, Act of August 22, 1940, c. 686, 54 Stat. 847, as amended, U.S.C.A., Title 15, § 80b-2(a)(13), as "the giving of continuous advice as to the investment of funds on the basis of the individual needs of each client." Section 202(a)(11) of the Investment Advisers Act, 54 Stat. 847, as amended, U.S.C.A., Title 15, § 80b-2(a)(11), after defining "investment adviser," provides that the term "does not include . . . a bank." An investment adviser whose only clients are investment companies need not register under the Investment Advisers Act of 1940 (Section 203(b)(2), 54 Stat. 850, as amended, U.S.C.A., Title 15, § 80b-3(b)(2)).

The Commission granted the exemptions from Section 10(b)(3) and 10(c) (JA 72). It denied the request under Section 10(d) (JA 73). Subsequently, by an amended order (JA 73-74), the Commission granted an exemption from Section 10(b)(2). Section 10(b)(2), in effect, as here pertinent, would have prohibited a majority of the Committee from being comprised of persons who were officers or directors of the Account's principal underwriter (*i.e.*, here the Bank). As a result of the Commission's determination, the make-up of the Committee is governed by Section 10(a) of the Investment Company Act, which, as we have noted, provides that no more than 60 per cent of the members of the Committee (*i.e.*, no more than 3 of 5) may be officers, directors or employees of the Account's investment adviser. Hence at least 40 per cent of the members of the Committee (*i.e.*, at least 2 of 5) must be comprised of persons who are not affiliated with the Bank.

In connection with each exemption granted, the Commission considered the statutory purposes and objectives of the particular provisions of the Investment Company Act and determined that the manner in which the Account was organized and in which it was to operate would not be violative of such purposes and objectives. With respect to Section 10(c), the Commission concluded that the Bank "has shown that substantial safeguards are present here against the conflicts of interest which could arise as a result of the Bank's commercial banking activities" (JA 62). With respect to the request for exemption from Section 10(b)(3), the Commission found no "basis for concern that the Bank, *qua* investment banker, can or will use the Account to its advantage, particularly since the Account is primarily a stock fund and the Bank is limited to underwriting debt securities

of government authorities" (JA 65). The Commission concluded that the same reasons made an exemption "necessary or appropriate" from Section 10(b)(2) "in view of the no-load character of the Account" (JA 74).

SUMMARY OF ARGUMENT

The exemptions granted by the Commission under Section 6(c), which permit a maximum of 3 instead of 2 Bank officers or directors to serve on the five-member Committee, allow the Account to function in conformity with both the Investment Company Act of 1940 and the federal banking laws so that investors will have the basic protections of the Investment Company Act and at the same time be provided with a choice of an investment media not previously available.

The Commission properly found that the Account was not the type of investment entity with which Congress was concerned in adopting Section 10(c), which precludes officers and directors of any one bank from constituting the majority of the board of directors of an investment fund. Section 10(c) was designed to prevent the abuses that had resulted from the activities of security affiliates of commercial banks—a type of organization differing substantially from a collective investment fund such as the Account, which was unknown at the time of the passage of the Investment Company Act in 1940. The Commission's broad exemptive powers under Section 6(c) were intended to take care of situations unknown when the Act was passed where otherwise applicable protections appear unnecessary.

The Account's characteristics, the Bank's undertakings, and regulation by the federal banking authorities, as well as the numerous protective provisions

of the Investment Company Act from which no exemption has been granted, provide substantial safeguards against possible conflicts of interest arising as a result of the Bank's commercial banking activities.

The Act recognizes that investment companies are often under the substantial control of their sponsors or investment advisers and assumes that this does not prevent its directors from carrying out their functions. Similarly, the control here by the Bank will not prevent the Committee of the Account, which has every power and responsibility provided by the Act for directors of such investment companies, from carrying out its functions.

ARGUMENT

I. The result reached by the Commission was within the bounds of its discretionary authority under Section 6(c) of the Investment Company Act of 1940.

Under Section 6(c) of the Investment Company Act, the Congress has granted the Commission authority to exempt any person from any provision of the Act provided such action is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act. In reaching its result in the present case, the Commission adhered to its guideline, previously formulated,²² that the standards of Section 6(c) mean that the propriety of the Commission's exercising its exemptive authority "largely depends upon the purpose of the section from which an exemption is requested, the evils against which it is directed, and the end which it seeks to accomplish'" (JA 59). The NASD appar-

²² *Transit Investment Corporation*, 28 S.E.C. 10, 16 (1948). See also *American Participations, Inc.*, 10 S.E.C. 431 (1941) and cases cited in n. 17 of the *Transit Investment* case.

ently does not challenge the validity of this guideline; it does urge, however, that in exercising its exemptive authority in this case the Commission disregarded "the statute's mandate" and "substituted its policy judgment for that of the Congress" (NASD Br. 30). The Commission found that the purposes of Section 10 from which exemptions were granted were not frustrated by the Bank's proposal and that the investors in the Account would receive adequate protections.

The NASD's challenge to the Commission's action appears to be not so much the contention that the Commission afforded undue latitude to the Bank contrary to the policies and purposes of the Act, but rather that the Commission may not permit the Account legally to exist and be operated consistently with the requirements of both the Investment Company Act and the federal banking laws and regulations. The NASD does not dispute that the Account is an investment company. Its basic contention, repeated in various ways throughout its brief, is that under the Investment Company Act the Account must be construed as a separate entity which cannot be controlled by the Bank, while under the Comptroller's regulations and the decision of the Federal Reserve Board, it must be construed as an arm or department of the Bank. Thus, it claims there is an impasse.²⁹

The Commission determined that no such impasse exists—the Account can be considered by the Commission as a separate entity and operated in a manner consistent with the purposes and policies of the Act and in a way which affords to investors the protections contemplated by the Act; at the same time, the Account can be construed by the banking authorities as part of the Bank in the sense that it may be under the

²⁹ Concern that such an impasse might exist prompted a critical report by the House Committee on Government Operations

control of the Bank. This concept is not restricted to the banking laws. Thus a fund of securities controlled by an insurance company is considered a part of the insurance company under state insurance regulation, but a fund, as a separate account, must be registered as an investment company under the Investment Company Act.²⁰

By granting exemptions permitting the Account to comply with the banking laws and with the Investment Company Act, the Commission acted in accordance with an underlying policy of the latter Act that investors should have a broad choice of investment media. That policy is evidenced by the fact that anyone who has not been convicted of specified crimes or found by a court of competent jurisdiction to have engaged in specified acts of misconduct may form and register an investment company.²¹ Thus, since, as we

which suggested that such a conflict in the administration of federal statutes was unseemly and undesirable. H.R. Rep. No. 429, 88th Cong., 1st Sess. (1963). It also prompted the introduction of legislation which would have exempted such accounts from all provisions of the federal securities laws. S. 2704, 89th Cong., 2d Sess. (1966). The Commission opposed such legislation upon the ground that it was unnecessary and undesirable to deprive investors in such accounts of all the protections of the federal securities laws. *Hearings on S. 2704 Before a Subcommittee of the Senate Committee on Banking and Currency*, 89th Cong., 2d Sess., 132-139 (1966).

²⁰ See *Prudential Insurance Company of America*, Investment Company Act Release No. 3620 (January 22, 1963), *aff'd* 326 F. 2d 383 (C.A. 3, 1964), *certiorari denied*, 377 U.S. 953. The following insurance companies have registered separate accounts as investment companies: Horace Mann Life Insurance Company Separate Account, Commission File Nos. 2-24256, 811-1343; The Paul Revere Variable Annuity Contract Accumulation Fund, File Nos. 2-24380, 811-1356; National Variable Annuity Company of Florida Separate Account, File Nos. 2-23902, 811-1327.

²¹ See Section 9(a) of the Act, 54 Stat. 805, U.S.C.A., Title 15, § 80a-9.

will show below, the Account can be operated in a manner consistent with the Act, the Commission's grant of those exemptions necessary to permit it to function in conformity both with the Act and with the federal banking laws furthers the basic policy of free competition. Banks with their long experience in managing other peoples' money in a fiduciary capacity may well be able to make a contribution to the available investment opportunities in the investment company field.²²

A. The Commission properly found that the Account is not the kind of investment entity intended to be prohibited by Section 10(c).

The Commission's initial inquiry, and properly so under its established guideline, was whether Section 10(c) was enacted to cover the type of investment fund proposed in the Bank's application. As we have seen, under Section 10(c) of the Act a majority of the board of directors of an investment company may not be officers or directors of any one bank. It is the Commission's action in granting the Account an exemption from this provision which receives the greatest attention of the NASD.

The first fact found by the Commission to be significant was that a collective investment fund of the type proposed by the Bank could not have existed until 1963 (JA 60). Since commingling of managing agency accounts of banks was not authorized in 1940, the new proposal came within a type of situation where

²² In urging that a separate account established by an insurance company to issue variable annuities must be registered under the Investment Company Act, the NASD has stated:

"The National Association of Securities Dealers is concerned that competition in the fashioning of investment devices . . . be kept open to all companies qualified to issue them." (Page 23 of Brief for the National Association of Securities Dealers, Inc., in *Prudential Insurance Co. v. Securities and Exchange Commission*, *supra* at note 30.)

Congress expected the Commission to determine whether to exercise its authority under Section 6(c). The Commission concluded that one of the purposes of Section 6(c) was to "take care of special situations . . . that could not be foreseen at the time the legislation was drafted" (JA 59).³³

Next, the Commission found the Account to be "substantially different, both in purpose and nature of operation, from the bank-dominated investment companies described in this Commission's Report to Congress on Investment Trusts and Investment Companies, which led to the passage of the Act, and in the testimony at the Congressional hearings" (JA 60). That report of the Commission describes the manner in which commercial banks, particularly during the 1920's, had organized associated companies known as bank security affiliates. These security affiliates frequently assumed the form of, or sponsored, companies which would now be classified under the Investment Company Act as closed-end investment companies. The shares of the security affiliates were generally sold or issued to the banks' shareholders on a share for share basis and provision was made for maintaining the inseparability of the bank stock and the stock of the security affiliates. The various activities of the security affiliates were described by the Commission's Report as follows:

"The sphere of activity of these security affiliates embraced the wholesaling and retailing of security issues; serving as holding and finance companies in carrying blocks of securities, for control or otherwise, which the bank could not or would not list among its own investments; assuming such loans and investments of the par-

³³ The Commission was quoting from a previous case, *The Atlantic Coast Line Company*, 11 S.E.C. 661, 666-667 (1942).

ent bank which might prove doubtful and non-liquid; supporting the market in the bank's own stock; and finally acting as investment companies in buying and selling securities for investment or speculative purposes."²⁴

Predominant among the abuses resulting from the operation of such security affiliates was the loaning by the banks of large amounts to their security affiliates to finance the purchasing of securities. The Commission's *Report on Investment Trusts and Investment Companies* refers to the Congressional hearing which led to the adoption of the Banking Act of 1933, where it was stated:

"Activities of a bank's security affiliate as a holding or finance company or an investment trust are also fraught with the danger of large losses during a deflation period. Bank affiliates of this kind show a much greater tendency to operate with borrowed funds than do organizations of this type which are independent of banks, the reason being that the identity of control and management which prevails between the bank and its affiliate tends to encourage reliance upon the lending facilities of the former."²⁵

Another major abuse consisted of the activities of the security affiliate in supporting the market price of the bank's own stock. See *Stock Exchange Practices, Report of the Committee on Banking and Cur-*

²⁴ *Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pt. 1, H.R. Doc. No. 707, 75th Cong., 3d Sess. 94 (1938).*

²⁵ *Hearings Pursuant to S. Res. 71 Before a Subcommittee of the Senate Committee on Banking and Currency, 71st Cong., 3d Sess. 1058 (1931).*

rency, S. Rep. No. 1455, 73d Cong., 2d Sess., 168 *et seq.* (1934).

The Account here is not at all comparable to the security affiliates. The Board of Governors of the Federal Reserve System has determined that the proposed arrangement does not violate Section 32 of the Banking Act of 1933, which was apparently designed to curb interlocking relationships between commercial banking and investment banking (JA 57). In addition, under one of its fundamental policies (JA 17), the Account cannot borrow from the Bank (or from anyone else) and under Section 12(d)(3) of the Investment Company Act, 54 Stat. 808, U.S.C.A., Title 15, § 80a-12(d)(3), and Rule 2a-3, 17 CFR 270.2a-3, thereunder, it cannot purchase stock issued by the Bank. Moreover, the management agreement between the Bank and the Account is designed to minimize possible conflicts of interest, by prohibiting the Bank, its officers, directors or employees from effecting transactions with the Account (JA 34). Accordingly, the Account cannot become a vehicle for the Bank doing indirectly that which it may not do directly under the banking laws, the main purpose served by the security affiliates.

While the NASD quotes extensively from the legislative hearings preceding enactment of the Investment Company Act (NASD Br. 12-16) in which the various evils stemming from bank-related investment companies are set forth, it overlooks the fact that the evils uncovered by the Commission's study related to security affiliates, investment vehicles much different from the Account.* The significance of the fact that

*The NASD suggests that the Commission has held that Section 10(c) "was intended to apply only to closed-end investment companies," thus truncating the statute (NASD Br. 24). In pointing out that the evils sought to be remedied related to

Section 10(c) was designed to curb evils connected with a certain type of investment company, *i.e.*, a bank security affiliate, is meaningful in determining whether the evils sought to be eliminated could occur with respect to the proposal before the Commission. The NASD would apparently have the Commission end its consideration of the matter once it has found that Section 10(c) prohibits bank-dominated investment companies. If this were the Congressional intent, the Commission's exemptive power under Section 6(c) would have been made inapplicable to Section 10(c). It clearly was not. In this connection, the Commission stated (JA 60):

“In *Transit Investment Corporation*, we held that the “purposes fairly intended by the policy and provisions” of the Act obviously means something more than a literal reading only of the provision from which an exception is desired. Otherwise, the existence of a provision prohibiting a transaction, which in every case under Section 6(c) is the very reason why an application for exemption is necessary, would also be the very reason for denying the application, thus making it impossible to resort to Section 6(c) to exempt a transaction from any provision of the Act’.”

a particular type of closed-end investment company, the Commission did not determine that Section 10(c) was to be applied only to closed-end investment companies. The Commission merely noted, for the reasons stated above, that Section 10(c) “was not directed at the *type* of open-end investment company represented by the Account” (emphasis added) (JA 60). In the case of any open-end investment company where evils sought to be avoided by the Act should be found to require the protections of Section 10, no exemptions would be granted.

B. The Commission's conclusion that there are substantial safeguards against the conflicts of interest which could arise as a result of the intervenor's commercial banking activities was warranted by the facts.

The NASD contends that "Section 10(c) is a shield to protect investors against all conflicts in the bank interlock, whether evident or subtle, existing or potential" (NASD Br. 29) and seems to imply at various places in its brief (see, *e.g.*, NASD Br. 28) that the Commission would have had to find that there is no possibility of the existence of any conflict of interest before granting relief from Section 10(c) of the Act. The Commission carefully examined the potential areas of conflicts of interest (JA 66). These included the danger that the Account's brokerage business might be placed to favor the brokerage firms who are depositors of the Bank, that the Account would retain a large amount of cash deposits in the Bank, and that the Account's funds would be used to "shore up" bank investments.³⁷

The Commission found that any abuses in the first area were resolved by the Bank's undertaking to place the Account's brokerage business in a manner which would not permit the Bank to favor its depositors (JA 63).

As to the other areas of potential conflict, the Commission recognized that precisely the same potential conflicts of interest exist in any situation in which a bank, as trustee, manages the assets of others and that the federal banking authorities were fully aware of this potential and, in the course of their supervision

³⁷ Another danger cited, the purchase of securities underwritten by the Bank, is discussed, *infra*, under Section 10(b)(3). These potential dangers had been cited by a former Chairman of the Commission in testimony before the Congress. *Hearings on Common Trust Funds—Overlapping Responsibility and Conflict in Regulation Before a Subcommittee of the House Committee on Government Operations*, 88th Cong., 1st Sess., 11-12 (1963).

of the bank's performance of its fiduciary functions, would take various steps to guard against these potential conflicts. The Commission pointed out that "[a]mong other things, the Comptroller's office, as part of its periodic examination of national banks, examines the investments held by the Bank as fiduciary to determine whether such investments are in accordance with law, Regulation 9 [12 CFR 9] and sound fiduciary principles" (JA 62). The Commission concluded that these safeguards together with various provisions and restrictions in other sections of the Act which are designed to guard against conflicts of interest would, in conjunction, provide adequate safeguards.

The NASD dismisses the Commission's reliance upon the Comptroller's supervision by merely quoting (NASD Br. 26) the Commission's statement to the effect that such supervision is not a substitute for the protections afforded investors by the Investment Company Act. The NASD misses the point. The Commission's reasoning is that this additional safeguard of federal regulation by another agency of the Government is a basis for lessening the necessity for strictly applying certain of the provisions of Section 10 of the Act. The Account is subject to all of the other provisions of the Act and investors receive the benefits of the protections provided thereby. The Commission concluded that under all the circumstances of the case the independent check on management provided for in Section 10(a) of the Act, that is, a board of directors 40% of the members of which were unaffiliated with the Bank, would adequately protect investors where the management acted in conflicts-of-interest situations and that the present case did not present the type of situation for which Con-

gress had enacted the more stringent provisions of Section 10(c).

The importance of the NASD's challenge to the Commission's grant of an exemption from Section 10(b)(3) is somewhat measured by the fact that its argument is relegated to a footnote (NASD Br. 28, n. 57). Under Section 10(b)(3) the board of directors of the Account may not have a member who is affiliated with an investment banker unless a majority is not affiliated with investment bankers. Section 10(b)(3) was designed to prevent an investment banker from using the funds of the investment company to promote its investment banking business. While the Bank is in the investment banking business to the extent that it participates in syndicates which underwrite United States Government and municipal obligations, the Account, as noted by the Commission (JA 65), is primarily a stock fund. The Account cannot purchase any securities from the Bank (JA 34). Moreover, if the Account were to purchase governmental obligations, under applicable statutory provisions the Account could not purchase these securities from another member of an underwriting syndicate where the Bank participates as a principal underwriter."

II. In the absence of any showing to the contrary, the Commission was entitled to assume that the directors of the Account would comply with the provisions of the Investment Company Act of 1940.

The basic argument of the NASD on this point (NASD Br. 36-40) is that the Committee will be un-

"To resolve any doubt, the Commission imposed a condition to the exemption that the prohibition against purchasing government securities from such syndicate members be extended to include the situation where the syndicate has terminated but its members have not sold certain of the securities which were allotted to them by the syndicate (JA 65, 72-73).

able to perform its functions under the Investment Company Act because the banking laws contemplate that the Bank and its board of directors will exercise control over the Account and be responsible for its investments. This does not follow. The fact that a majority of the members of the Committee will be affiliated with the Bank does not prevent the Committee from carrying out its functions under the Investment Company Act. As we have seen, *supra* at page 9, investment companies are usually controlled by their investment advisers and the Act assumes that such relationships will exist. That the Bank will make the initial investment decisions subject to post-audit by the Committee (JA 32) is a situation expressly recognized by the Act. As is apparent from the definition of investment adviser in Section 2(a)(19), an investment adviser of an investment company may be "empowered to determine what securities or other property shall be purchased or sold by such company."³⁰

The Commission, contrary to the NASD's contention (Br. 35-36), did state the basis for its conclusion that the Committee and not the directors of the Bank will be entrusted with the directorial responsibilities for the Account. The Commission stated that the banking laws do not preclude the Committee from performing its responsibilities under the securities

³⁰ Section 2(a)(19), 54 Stat. 790, as amended, U.S.C.A., Title 15, § 80a-2(a)(19), provides in pertinent part:

"'Investment adviser' of an investment company means (A) any person (other than a bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company. . . ."

acts (JA 79). The reason given by the Commission, which met the requirements of Section 8(b) of the Administrative Procedure Act, Act of June 11, 1946, c. 19, 60 Stat. 242, U.S.C.A., Title 5, § 1007(b), was that the Federal Reserve Board in its decision⁴⁰ recognized that the Committee would have to comply with the securities laws and that supervision of the Account would be in the hands of a Committee elected by investors.⁴¹

The NASD has not pointed to any functions required of a board of directors under the Investment Company Act which cannot be performed by the Committee. Just as the participants in the Account have

⁴⁰ 12 CFR 218.111.

⁴¹ Similarly, the Comptroller was aware that the Committee would exercise supervision over the Account. The letter of the Comptroller approving the arrangement for the Account under Section 9.18(c)(5) of Regulation 9 (JA 47-52) explicitly recognized, among other things, that:

"The commingled account will operate as follows. The supervision of the commingled account will be in the hands of a committee, the members of which will initially be appointed by the bank but thereafter elected by the participants at annual meetings. It is expected that officers of the bank will be members of the committee, except that at all times there will be at least one member who is independent of the bank. Pursuant to a management agreement with the committee, the bank will be responsible for the management of the investments in the commingled account, will have custody of the assets in the commingled account, will handle all transactions in the portfolio of the commingled account, and will maintain the records and keep the books of the commingled account.

"The management agreement shall be subject to the approval of the participants at their first annual meeting. The management agreement will remain in force for two years from the date of its execution and is renewable annually thereafter, provided that such continuance is approved annually by the committee, including a majority of the members of the committee who are not directors, officers, or employees of the bank, or by vote of participants having a majority of units of participation. . . ." (JA 48-49).

every voting right prescribed by the Act for shareholders of a registered open-end investment company," so also the Committee of the Account has every power and responsibility prescribed by the Act for directors of such an investment company. While, as in the case of most investment companies, it can be expected that the board of directors will be favorably disposed toward the investment adviser, whose affiliated persons constitute a majority of the board, nevertheless the Committee has the same legal obligations as any board of directors of an investment company. A director or a member of the Committee, whether affiliated or unaffiliated, who shirks his responsibility to the participants in the Account is subject to liability for damages," he is also subject to

⁴² *E.g.*, pursuant to Sections 13(a) [54 Stat. 811, U.S.C.A., Title 15, § 80a-13(a)], 15(a), 16(a) and 32(a) of the Act, the investment policy of the Account may not be changed without approval of the participants by majority vote (JA 16); the participants may by majority vote terminate the management agreement at any time on 60 days notice (JA 25); the management agreement will not continue in effect beyond the first annual meeting of the participants unless it is approved at that meeting by a majority vote (JA 25) and the agreement may not be amended without the approval of the participants by majority vote (JA 25); the participants will elect all members of the committee at the first and subsequent annual meetings of the participants (JA 55, 68); and the selection of the independent public accountant for the Account must be submitted annually to participants for ratification or rejection by majority vote (JA 28). The Commission's proxy rules under Section 20(a) of the Act will apply to solicitation of proxies of participants.

⁴³ In *Brown v. Bullock*, 294 F. 2d 415, 421 (C.A. 2, 1961), the court said:

"When Congress mandated annual approval of investment advisory and underwriting contracts, it must have been concerned with the substance and not simply the form. . . . We think § 15 (a) and (b) [of the Investment Company Act] laid

an action under Section 36 of the Act for his removal or suspension from office. There is no legal impairment to the Committee's performing its statutory responsibilities of annually reviewing the management agreement to determine whether to renew the contract or to recommend its renewal to participants" (JA 25, 35); nor is there any legal obstruction to the Committee terminating the management agreement at any time on 60 days notice, pursuant to Section 15(a)(3) (JA 25, 35). Moreover, pursuant to Section 2(a)(39), 54 Stat. 790, as amended, U.S.C.A., Title 15, § 80a-2(a) (39), the Committee members must determine the fair value of any assets of the Account for which market quotations are not readily available (JA 19). Pursuant to Section 30, 54 Stat. 836, U.S.C.A., Title 15, § 80a-29, the Committee must file periodically and transmit to participants required reports (JA 28, 34). The Committee is also responsible for the accuracy and adequacy of the Account's registration statement, including the prospectus, under the Securities Act of 1933. As described in the prospectus the Committee will also determine the dividend policy of the Account (JA 23) and will determine to what extent distributions upon termination of a participation will be made in cash and to what extent in kind (JA 22).

The NASD has no factual basis for asserting that the Committee will not conscientiously perform its responsibilities. Instead, it relies upon certain of the banking regulations, particularly Section 9.7

down a requirement of annual approval not merely formal but substantial, the minimum content of which is a matter of federal law; hence a complaint alleging failure to conform to that requirement sets forth a federal claim."

"If the Committee elected to renew the contract without shareholder approval, such renewal would have to be approved by a majority of the unaffiliated directors. Section 15(c) of the 1940 Act.

(a)(1) of the Comptroller's regulations (12 CFR 9.7(a)(1)), in an attempt to create a legal basis for objection (NASD Br. 38). The short answer to the NASD's contention is that the Committee of the Account is not the type of committee referred to in Section 9.7(a)(1). That regulation in effect, states that while a bank may function through its officers or a committee of the bank, the board of directors of a bank cannot avoid responsibility by acting through such officers or committees. But the Committee in question here is not an internal committee of the Bank. This is evident since the Committee is to be elected annually by shareholders (JA 27) and is responsible to them for the proper discharge of its responsibilities.⁴⁵

CONCLUSION

The Account is something entirely new and different from the security affiliates of banks which were a source of Congressional concern in 1940. Because investment media such as the Account were not foreseen by Congress in 1940, certain exemptions from the Act were necessary in order to permit it to operate in conformity with applicable provisions of law; the Commission granted those exemptions and no others. Since the Commission could, and did, find that the Account could be operated in conformity with all of the purposes and policies of the Act, the Commission was not required, by withholding appro-

⁴⁵ Cf. *Brown v. Bullock*, *supra*, at n. 43. Only initially—until the first annual meeting of shareholders—is the Account exempted from Section 16(a) of the Act which requires that members of the Committee be elected annually by the participants in the Account (JA 8, 11, 72). The Commission normally grants such an exemption to newly formed investment companies to permit them to operate until the first annual shareholders' meeting (JA 68).

priate exemptions, in effect, to deny the Account the right to exist and to serve those investors who wish to participate in it.

For the foregoing reasons the Commission's orders should be affirmed.

Respectfully submitted.

PHILIP A. LOOMIS, Jr.,
General Counsel,

DAVID FERBER,
Solicitor,

LEONARD S. MACHTINGER,
Attorney,
Securities and Exchange Commission,
Washington, D.C. 20549.

Of Counsel:

JOHN A. DUDLEY,
Assistant Director,

ROBERT E. OLSON,
Special Counsel,

Division of Corporate Regulation,
Securities and Exchange Commis-
sion.

OCTOBER 1966.

BRIEF FOR INTERVENOR

IN THE
United States Court of Appeals
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 20,164

NATIONAL ASSOCIATION OF SECURITIES
DEALERS, INC.,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent,

FIRST NATIONAL CITY BANK,
Intervenor.

**On Petition to Review Orders of the
Securities and Exchange Commission**

SAMUEL E. GATES,
United States Court of Appeals 320 Park Avenue,
for the District of Columbia Circuit New York, New York 10022,

FILED OCT 24 1966

STEPHEN AILES,
1250 Connecticut Avenue,
Washington, D. C. 20036,
Attorneys for Intervenor.

Nathan J. Paulson

CLERK
DEBEVOISE, PLIMPTON, LYONS & GATES,
STEPTOE & JOHNSON,
Of Counsel.

Questions Presented

First National City Bank, intervenor herein, respectfully submits that the questions presented are:

1. Whether this Court should dismiss a petition for review of orders of the Securities and Exchange Commission exempting a bank collective investment fund (which charges no sales load) from certain provisions of the Investment Company Act of 1940, where petitioner is an association of brokers and dealers who have made no showing of direct injury resulting from such orders and whose only interest, if any, is in the protection of commissions derived from the sale of mutual fund shares.

2. Whether the Commission acted within the scope of its discretionary authority under Section 6(c) of the Investment Company Act of 1940 in exempting a bank collective investment fund from certain provisions of Section 10 of that Act, where the only effect was to reduce from three (a majority) to two (40%) the number of directors of the fund required to be unaffiliated with the bank.

3. Whether, in the absence of any showing to the contrary, the Commission was entitled to assume that the directors of the bank collective investment fund would discharge the directorial responsibilities contemplated by the Investment Company Act of 1940.

IN THE
United States Court of Appeals
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 20,164

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent,

FIRST NATIONAL CITY BANK,
Intervenor.

On Petition to Review Orders of the
Securities and Exchange Commission

BRIEF FOR INTERVENOR



INDEX

	PAGE
COUNTER-STATEMENT OF THE CASE	1
SUMMARY OF ARGUMENT	8
ARGUMENT	11
I. The NASD lacks standing to seek review of the Commission's orders	11
II. The exemptions from Section 10 of the Act were properly granted by the Commission	12
A. The scope of the contested exemptions is narrow	12
B. The power given the Commission by Section 6(c) to grant exemptions from the Act is more than broad enough to cover the Bank's exemptions	14
C. The Commission's action in exempting the Commingled Account from Section 10(c) was consistent with the statutory standards governing the exercise of the Commission's exemptive power	19
1. Section 10(c) was directed at abuses associated with closed-end investment companies totally unlike the Com- mingled Account	20
2. The Commingled Account is a type of investment company which was un- known in 1940, and it is a reasonable assumption that, had the Commingled Account been known, it would have been completely exempted from the Act as are the common trust funds which it so closely resembles	27

	PAGE
3. The potential conflicts of interest which have been attributed to bank-sponsored collective investment funds are adequately regulated in the case of the Commingled Account	31
D. The exemptions from Section 10(b) of the Act were also properly granted	34
E. The Commission has acted in the public interest and consistently with the protection of investors and the purposes of the Act; its orders should be affirmed	36
III. The Commission properly assumed that the Committee members will discharge the directorial responsibilities contemplated by the Act	38
CONCLUSION	48

Table of Authorities Cited

Cases

<i>American Trucking Ass'n v. United States, I.C.C.</i> , 364 U. S. 1 (1960)	18
<i>Brown v. Bullock</i> , 294 F.2d 415 (2d Cir. 1961)	43
<i>Church of the Holy Trinity v. United States</i> , 143 U. S. 457 (1892)	16
<i>Gray v. Powell</i> , 314 U.S. 402 (1941)	38
<i>Institutional Investors Mutual Fund, Inc.</i> , 35 S.E.C. 72 (1953)	16, 18
<i>Investors Mutual, Inc.</i> , SEC Investment Co. Act Release No. 3635 (Feb. 15, 1963)	15
<i>Minneapolis & St. L. Ry. v. United States</i> , 361 U. S. 173 (1959)	48

	PAGE
<i>NLRB v. Fruit & Vegetable Packers & Warehousemen, Local 760</i> , 377 U. S. 58 (1964)	16
<i>National Securities Series</i> , SEC Investment Co. Act Release No. 4356 (Sept. 15, 1965)	16
<i>Prudential Ins. Co. of America</i> , SEC Investment Co. Act Release No. 3620 (Jan. 22, 1963), <i>aff'd</i> , 326 F. 2d 383 (3d Cir.), <i>cert. denied</i> , 377 U. S. 953 (1964)	18
<i>Savings Bank Investment Fund</i> , 24 S.E.C. 531 (1946)	18
<i>Scudder, Stevens and Clark Fund, Inc.</i> , 26 S.E.C. 158 (1947)	16
<i>SEC v. Variable Annuity Life Ins. Co. of America</i> , 359 U. S. 65 (1959)	14
<i>Transit Investment Corp.</i> , 28 S.E.C. 10 (1948)	16
<i>United States v. Mississippi Valley Generating Co.</i> , 364 U. S. 520 (1961)	15
<i>Variable Annuity Life Ins. Co. of America</i> , 39 S.E.C. 680 (1960)	18
Statutes	
Act of Sept. 28, 1962, Section 1, 76 Stat. 668, U.S.C.A., Title 12, §92a	3
Administrative Procedure Act, Section 8(b), Act of June 11, 1946, 60 Stat. 242, U.S.C.A., Title 5, §1007(b)	47, 48
Banking Act of 1933, Section 32, Act of June 16, 1933, 48 Stat. 194, as amended, 49 Stat. 709 (1935), U.S.C.A., Title 12, §78	24, 45

	PAGE
Investment Company Act of 1940, Act of Aug. 22, 1940, 54 Stat. 789, as amended, U.S.C.A., Title 15, §§80a-1 to 80a-52	<i>passim</i>
Section 1(b), 54 Stat. 790, U.S.C.A., Title 15, §80a-1(b)	24
Section 2(a)(5), 54 Stat. 791, U.S.C.A., Title 15, §80a-2(a)(5)	29
Section 2(a)(12), 54 Stat. 792, U.S.C.A., Title 15, §80a-2(a)(12)	13
Section 2(a)(19), 54 Stat. 793, U.S.C.A., Title 15, §80a-2(a)(19)	40
Section 2(a)(20), 54 Stat. 793, U.S.C.A., Title 15, §80a-2(a)(20)	12
Section 2(a)(39), 54 Stat. 796, U.S.C.A., Title 15, §80a-2(a)(39)	42
Section 3(c)(3), 54 Stat. 798, U.S.C.A., Title 15, §80a-3(c)(3)	2, 29, 30
Section 3(c)(4), 54 Stat. 798, U.S.C.A., Title 15, §80a-3(c)(4)	30
*Section 6(c), 54 Stat. 802, U.S.C.A., Title 15, §80a-6(c)	1, 8, 9, 10, 12, 14, 15, 16, 17, 18, 19, 27, 30, 37
Section 8(b)(1)(G), 54 Stat. 804, U.S.C.A., Title 15, §80a-8(b)(1)(G)	27
Section 10, 54 Stat. 806, U.S.C.A., Title 15, §80a-10	8, 15, 16, 42
Section 10(a), 54 Stat. 806, U.S.C.A., Title 15, §80a-10(a)	13, 16, 44
Section 10(b), 54 Stat. 806, U.S.C.A., Title 15, §80a-10(b)	34
Section 10(b)(2), 54 Stat. 806, U.S.C.A., Title 15, §80a-10(b)(2)	7, 12, 16, 36

* Authorities chiefly relied upon.

	PAGE
Section 10(b)(3), 54 Stat. 806, U.S.C.A., Title 15, §80a-10(b)(3)	6, 12, 34
Section 10(c), 54 Stat. 806, U.S.C.A., Title 15, §80a-10(c)	6, 9, 10, 12, 16, 17, 19, 20, 21, 23, 24, 26, 28, 30, 31, 32, 34
Section 10(d)(2), 54 Stat. 807, U.S.C.A., Title 15, §80a-10(d)(2)	6, 7
Section 10(f), 54 Stat. 807, U.S.C.A., Title 15, 80a-10(f)	27, 35
Section 12(d)(3), 54 Stat. 809, U.S.C.A., Title 15, §80a-12(d)(3)	27
Section 15(a)(2), 54 Stat. 812, U.S.C.A., Title 15, §80a-15(a)(2)	41
Section 15(a)(3), 54 Stat. 812, U.S.C.A., Title 15, §80a-15(a)(3)	42
Section 16(a), 54 Stat. 813, U.S.C.A., Title 15, §80a-16(a)	38, 39
Section 17(a), 54 Stat. 815, U.S.C.A., Title 15, §80a-17(a)	27, 35
Section 17(d), 54 Stat. 816, U.S.C.A., Title 15, §80a-17(d)	27, 35
Section 18(i), 54 Stat. 821, U.S.C.A., Title 15, §80a-18(i)	38, 39
Section 19, 54 Stat. 821, U.S.C.A., Title 15, §80a-19	42
Section 20(a), 54 Stat. 822, U.S.C.A., Title 15, §80a-20(a)	42
Section 21, 54 Stat. 822, U.S.C.A., Title 15, §80a-21	27
Section 30, 54 Stat. 836, U.S.C.A., Title 15, §80a-29	42

	PAGE
Section 32(a), 54 Stat. 838, U.S.C.A., Title 15, §80a-31(a)	42
Section 36, 54 Stat. 841, U.S.C.A., Title 15, §80a-35	33, 43
Section 43(a), 54 Stat. 844, as amended, U.S.C.A., Title 15, §80a-42(a)	8, 11, 48
Revised Statutes, Section 5136, para. Seventh, as amended, 48 Stat. 184 (1933), as amended, U.S.C.A., Title 12, §24 (¶ Seventh)	12, 35
*Revised Statutes, Section 5240, as amended, 70 Stat. 124 (1956), U.S.C.A., Title 12, §481	36
Securities Act of 1933, Act of May 27, 1933, 48 Stat. 74, as amended, U.S.C.A., Title 15, §§77a- 77aa	3, 6, 7, 10, 13, 42
Section 6(a), 48 Stat. 78, U.S.C.A., Title 15, §77f(a)	42
Section 11(a), 48 Stat. 82, as amended, U.S.C.A., Title 15, §77k(a)	42

Rulings and Regulations

Board of Governors of the Federal Reserve Sys- tem, 12 C.F.R. §218.111 (Supp. 1966)	24, 44, 45
Comptroller of the Currency, Regulation 9, 12 C.F.R. §9 (Supp. 1966)	3
Section 9.7(a)(1)	46, 47
*Section 9.11(d)	36
*Section 9.12	27
*Section 9.12(a)	35
Section 9.18(a)	5
*Section 9.18(b)	6, 47

* Authorities chiefly relied upon.

	PAGE
Section 9.18(b)(1)	6
Section 9.18(b)(12)	46, 47
Section 9.18(c)(5)	5, 6, 46
SEC Rule 2a-3 under the Investment Company Act of 1940, 17 C.F.R. §270.2a-3 (1964)	27

Congressional Materials

<i>Hearings Pursuant to S. Res. 71 Before a Subcommittee of the Senate Committee on Banking and Currency, 71st Cong., 3d Sess. (1931)</i>	<i>27</i>
<i>*Hearings on S. 3580 Before a Subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess. (1940)</i>	<i>20, 21, 22, 23, 28, 29, 30, 34</i>
<i>*Hearings on H.R. 10065 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 76th Cong., 3d Sess. (1940)</i>	<i>20, 23, 24, 36, 44</i>
<i>Hearing on Common Trust Funds—Overlapping Responsibility and Conflict in Regulation Before a Subcommittee of the House Committee on Government Operations, 88th Cong., 1st Sess. (1963)</i>	<i>3, 14, 31, 32</i>
<i>Hearings on H.R. 7372 Before the Subcommittee on Domestic Finance of the House Committee on Banking and Currency and the House Committee on Banking and Currency, 89th Cong., 1st Sess. (1965)</i>	<i>17</i>
<i>Hearings on S. 2704 Before a Subcommittee of the Senate Committee on Banking and Currency, 89th Cong., 2d Sess. (1966)</i>	<i>17, 46</i>
<i>S. 3580 and H.R. 8935, 76th Cong., 3d Sess. (1940)</i>	<i>20, 21, 22, 23</i>
<i>S. 4180 and H.R. 10065, 76th Cong., 3d Sess. (1940)</i>	<i>23, 24</i>
<i>H.R. 7482, 87th Cong., 1st Sess. (1961)</i>	<i>43</i>

* Authorities chiefly relied upon.

•SEC, *Report on Investment Trusts and Investment Companies:*

Part I—*The Nature, Classification, and Origins of Investment Trusts and Investment Companies*, H.R. Doc. No. 707, 75th Cong., 3d Sess. (1938) 25, 26, 28, 29

Part II—*Statistical Survey of Investment Trusts and Investment Companies*, H.R. Doc. No. 70, 76th Cong., 1st Sess. (1939) — 25, 26, 28

Part III—*Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies*, cc. 1-6, H.R. Doc. No. 279, 76th Cong., 1st Sess. (1939-1940), c. 7, H.R. Doc. No. 136, 77th Cong., 1st Sess. (1941) 25, 26

•SEC, *Report on Commingled or Common Trust Funds Administered by Banks and Trust Companies*, H.R. Doc. No. 476, 76th Cong., 2d Sess. (1939) 25, 28, 29

Wharton School of Finance and Commerce, *A Study of Mutual Funds*, H.R. REP. No. 2274, 87th Cong., 2d Sess. (1962) 5, 34, 41

Miscellaneous

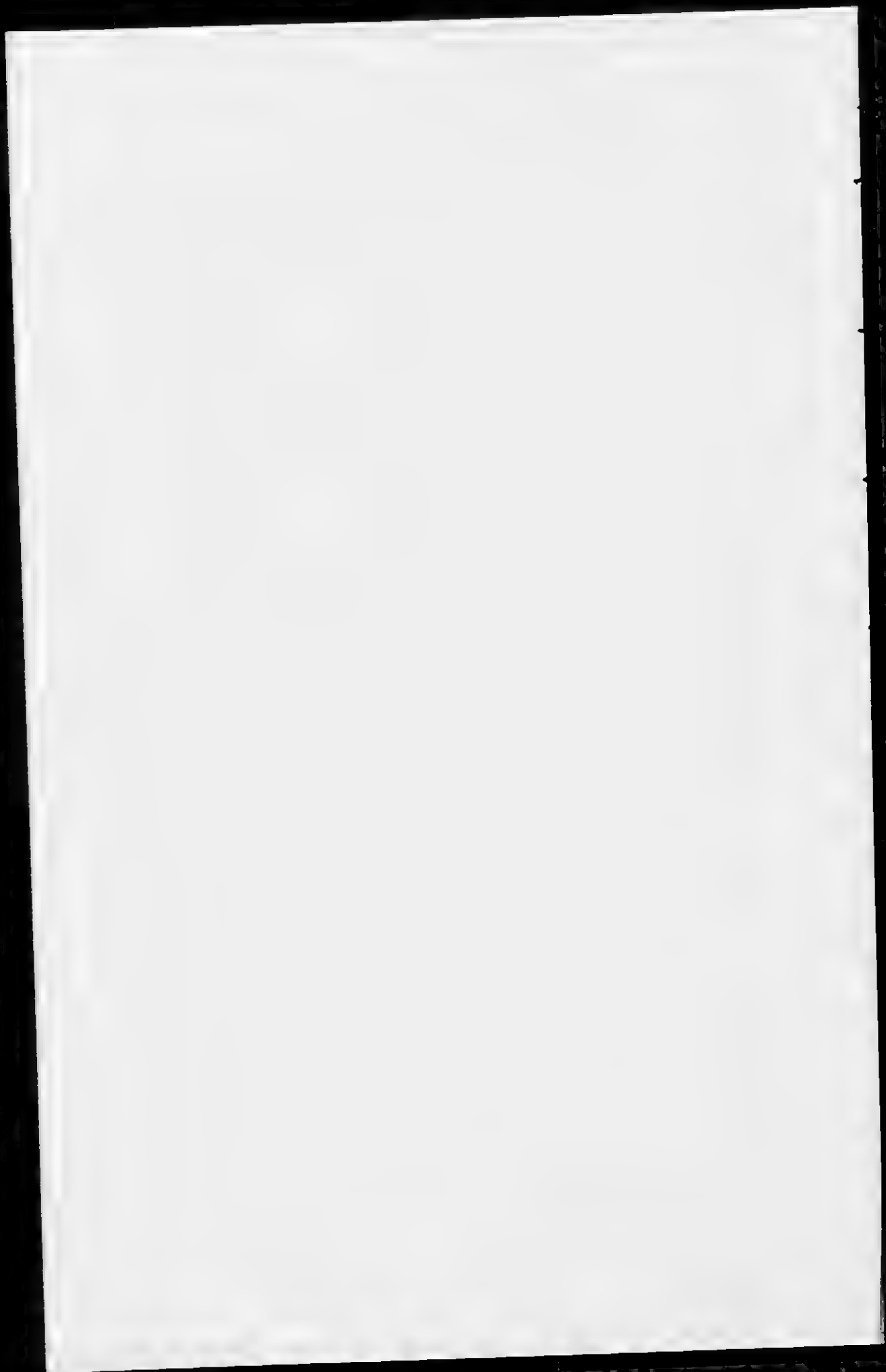
Comptroller's Manual for Representatives in Trusts (revised Aug. 23, 1965) 2, 32, 36

Board of Governors of the Federal Reserve System, Memorandum dated Dec. 15, 1965 46

Jaretzki, *The Investment Company Act of 1940*, 26 WASH. U.L.Q. 303 (1941) 14

* Authorities chiefly relied upon.

	PAGE
Jaretzki, <i>Duties and Responsibilities of Directors of Mutual Funds</i> , 29 LAW & CONTEMP. PROB. 777 (1964)	40, 41
Saxon & Miller, <i>Common Trust Funds</i> , 53 GEO. L. J. 994 (1965)	28
RESTATEMENT (SECOND), AGENCY (1958)	4, 33
Silverberg, <i>Growth and Performance of Common Trust Funds in 1964</i> , 2 NAT'L BANKING REV. 363 (1965)	2



IN THE
United States Court of Appeals
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 20,164

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
Petitioner,
v.
SECURITIES AND EXCHANGE COMMISSION,
Respondent,
FIRST NATIONAL CITY BANK,
Intervenor.

**On Petition to Review Orders of the
Securities and Exchange Commission**

BRIEF FOR INTERVENOR

COUNTER-STATEMENT OF THE CASE

In this proceeding the National Association of Securities Dealers, Inc. (the "NASD") is attempting to obtain review by this Court of certain orders issued by the Securities and Exchange Commission (the "Commission") under the Investment Company Act of 1940 (the "Act" or "1940 Act").¹

The proceeding below was initiated by First National City Bank (the "Bank"), intervenor herein,² by the filing of an application (JA 2) with the Commission pursuant to Section 6(c) of the Act³ requesting certain exemptions

1. Act of Aug. 22, 1940, 54 Stat. 789, as amended, U.S.C.A., Title 15, §§80a-1 to 80a-52.

2. Intervention was permitted by this Court's order filed June 3, 1966.

3. 54 Stat. 802, U.S.C.A., Title 15, §80a-6(c).

from the Act in connection with a proposed collective investment fund for managing agency accounts. This fund is known as the Commingled Investment Account of First National City Bank (the "Commingled Account").

In the banking industry, the term "managing agency account" is used to describe a fiduciary account where a bank provides safekeeping for the customer's funds and securities and manages the investments in the account pursuant to a power of attorney giving the bank broad investment discretion. Only those national banks which are authorized to exercise trust and other fiduciary powers (as is the Bank) may act as managing agent.⁴

First National City Bank has offered this type of investment advisory service for many years. Such agency accounts can be accepted for management on an individual basis, however, only when the customer's investment funds are substantial; otherwise, the minimum fee which the Bank must charge to cover its administrative costs becomes excessive in relation to the amount invested. As a result, the Bank has frequently had to turn away customers with smaller amounts who have wished to make use of the Bank's investment advisory services.⁵

4. See Opinion of the Comptroller of the Currency, set forth in the Comptroller's Manual for Representatives in Trusts at D-1 (revised Aug. 23, 1965) [hereinafter cited as Comptroller's Manual].

5. The problem of the administrative expense involved in holding securities, collecting and disbursing dividends, making purchases and sales and assuming responsibility for investment supervision on an individual basis is, of course, faced by banks in connection with the administration of smaller trusts and estates. But in this area banks have for many years been allowed to commingle the funds of such trusts and estates in common trust funds in order to obtain the resulting economies of collective investment. At the end of 1964, 425 banks and trust companies operated 800 common trust funds having assets of almost \$6 billion. Silverberg, *Growth and Performance of Common Trust Funds in 1964*, 2 NAT'L BANKING REV. 363 (1965). Such common trust funds are exempted from the Act by Section 3(c)(3), 54 Stat. 798, U.S.C.A., Title 15, §80a-3(c)(3).

In April 1963, the Comptroller of the Currency revised Regulation 9,⁶ which governs the exercise by national banks of their fiduciary powers, to permit for the first time the pooling of managing agency accounts for investment purposes in a collective investment fund.⁷ The revision of Regulation 9 cleared the way for the Bank to develop its proposal for the Commingled Account. The Bank was aware, however, through public statements by members of the Commission⁸ and through consultation with the Commission's staff, that the Commission would take the position that the Commingled Account would have to register under the Act as an investment company and that any interests in the Commingled Account would have to be registered as "securities" under the Securities Act of 1933.⁹ Accordingly, the Bank proposed a collective investment fund for managing agency accounts established under the Comptroller's Regulation 9 and conforming also to the laws administered by the Commission.

The Commingled Account works this way: A customer of the Bank who wishes to give the Bank custody and investment discretion with respect to his funds (\$10,000 or more) turns them over to the Bank pursuant to a broad

6. 12 C.F.R. §9 (Supp. 1966).

7. The authority to grant fiduciary powers to national banks and to issue regulations governing the exercise of such powers was transferred from the Federal Reserve Board to the Comptroller of the Currency by the Act of Sept. 28, 1962, Section 1, 76 Stat. 668, U.S.C.A., Title 12, §92a.

8. See, e.g., *Hearing on Common Trust Funds—Overlapping Responsibility and Conflict in Regulation Before a Subcommittee of the House Committee on Government Operations*, 88th Cong., 1st Sess. 9 (1963) [hereinafter cited as *Government Operations Hearing*].

9. Act of May 27, 1933, 48 Stat. 74, as amended, U.S.C.A., Title 15, §§77a-77aa.

authorization making the Bank the customer's managing agent. There is thus created at the outset a true fiduciary relationship of principal and agent between each customer and the Bank.¹⁰ The authorization includes specific authority for the Bank to invest the customer's funds, together with the funds of other customers who have given the same authorization, through the Commingled Account (JA 15). If the Bank is satisfied that the investment policy of the Commingled Account is suitable to the customer's needs, the Bank accepts the customer's account and, as his agent, adds his funds to the Commingled Account on one of the specified valuation dates (JA 21).

The customer's interest in the Commingled Account is expressed in terms of units of participation redeemable at any time at net asset value and each having one vote (JA 17, 18, 21, 26). Units of participation are transferable only to persons who have validly appointed the Bank as managing agent (JA 18), and, because of the underlying agency relationship, the interest of a participating customer (or "participant") terminates upon death or incompetency (JA 22). No broker or dealer is engaged to underwrite or distribute participations, and no sales load or redemption charge is imposed (JA 21).

The operation of the Commingled Account is subject to the supervision of a Committee initially appointed by the

10. See RESTATEMENT (SECOND), AGENCY §13, comment a (1958):

"The agreement to act on behalf of the principal causes the agent to be a fiduciary, that is, a person having a duty, created by his undertaking, to act primarily for the benefit of another in matters connected with his undertaking."

See also *id.* §425, comment a:

"The duties of an agent who has authority to make and to manage investments are similar to those of the trustee of a formal trust, except in so far as they are affected by the fact that the principal has control and may modify or determine the investments at any time."

Bank but thereafter elected annually by the participants (JA 3, 15, 27). As originally proposed, at least one member of the Committee would at all times be a person not affiliated with the Bank, while the others would be officers in the Bank's Trust and Investment Division (JA 4, 55).

The formulation and implementation of an investment program consistent with the investment policy of the Commingled Account is carried out by the Bank as investment adviser pursuant to a management agreement, which is subject to the approval of the participants at their first annual meeting and is renewable only if approved annually by the Committee (including a majority of the unaffiliated members) or the participants (JA 15, 24-25, 29-35). Pursuant to the management agreement, the Bank also provides custody for the portfolio securities of the Commingled Account and furnishes the administrative and clerical services necessary for its operation (JA 24-25, 30-31). For all of these services, the Bank receives a fee equal, on an annual basis, to $\frac{1}{2}$ of 1% of the average net asset value of the Commingled Account (JA 25, 34).¹¹

On May 10, 1965, the Comptroller of the Currency specifically approved the proposal for the Commingled Account (JA 47) pursuant to Section 9.18(c)(5) of Regulation 9.¹² Thereafter, the Bank, on August 24, 1965,

11. In addition to acting as custodian without additional charge, the Bank also absorbs the costs of transferring participations, disbursing dividends and printing and distributing the reports to the participants required by regulatory authorities. In the case of mutual funds these expenses are usually excluded from management fees and paid by the funds themselves. See Wharton School of Finance and Commerce, *A Study of Mutual Funds*, H. R. REP. No. 2274, 87th Cong., 2d Sess. 67 (1962) [hereinafter cited as Wharton School Study].

12. 12 C.F.R. §9.18(c)(5) (Supp. 1966). A national bank may establish a collective investment fund without the Comptroller's approval if the fund takes one of the forms specified in Section 9.18(a) of Regulation 9, 12 C.F.R. §9.18(a) (Supp. 1966). Because the Commingled Account took a somewhat different form, the

filed with the Commission an application (JA 2) for an order exempting the Commingled Account from certain provisions of the Act, including Sections 10(b)(3), 10(c) and 10(d)(2).¹³ These particular exemptions were necessitated by the proposal that no more than one of the members of the Committee be required to be unaffiliated with the Bank.

On September 2, 1965, the Commission issued its notice of the filing of the Bank's application and gave "any interested person" an opportunity, until September 20, to submit a request in writing for a hearing on the matter (JA 36, 41). Belatedly, on October 1, the NASD filed such a request.¹⁴ Later, the NASD informed the Commission that it sought only an opportunity to file a brief and be heard in support of its position; it stated that it was not seeking an evidentiary hearing.¹⁵ The Commission permitted the NASD to participate to the extent requested, but expressly declined to pass on the question, urged by the Bank, that the NASD and other objectors

specific approval provided for in Section 9.18(c)(5) was requested. The Commingled Account will comply with each of the restrictive provisions of Section 9.18(b) of Regulation 9, 12 C.F.R. §9.18(b) (Supp. 1966), relating generally to collective investment funds, except in the few instances where compliance with the 1940 Act has made it difficult or impossible to conform to Regulation 9. The Commingled Account's prospectus under the Securities Act of 1933 also constitutes the plan of operation required by Section 9.18(b)(1) of Regulation 9, 12 C.F.R. §9.18(b)(1) (Supp. 1966). In connection with the Comptroller's approval, the Bank represented that there would be restrictions on advertising the Commingled Account and the manner in which participation would be made available. See JA 48.

13. 54 Stat. 806, 807, U.S.C.A., Title 15, §§80a-10(b)(3), -10(c), -10(d)(2).

14. See Request for Hearing on Behalf of NASD, included in the record as Document No. 6.

15. See letter dated October 11, 1965 from counsel for NASD to the Commission, included in the record as Document No. 11.

were without standing to request a hearing or to participate therein (JA 43, 54 n.3).

Briefs in support of the Bank's application were filed by the Bank and the Commission's Division of Corporate Regulation. Statements in support of the application were filed by the Comptroller of the Currency and the Federal Deposit Insurance Corporation. The NASD, the Investment Company Institute and the Association of Mutual Fund Plan Sponsors, Inc. filed briefs in opposition. Thereafter, the Commission heard oral argument.

On March 9, 1966, as corrected March 14, 1966, the Commission issued its Findings and Opinion and Order (JA 52, 72, 73) granting the exemptions requested except that from Section 10(d)(2). In lieu of this exemption, the Commission granted an exemption from Section 10(b)(2) of the Act.¹⁶ The effect of the exemptions granted was to permit 60% (or 3 out of 5) of the members of the Committee for the Commingled Account to be officers of the Bank. On April 6, 1966, the Commission denied (JA 77) a petition for rehearing filed by the NASD (JA 75). On May 5, 1966, the NASD filed in this Court its petition for review of the Commission's orders.

The Commingled Account was registered with the Commission on April 20, 1966 as an open-end investment company pursuant to the provisions of the 1940 Act. The Commingled Account has been in operation since June 1966, when the Commission declared effective the Commingled Account's registration statement filed pursuant to the Securities Act of 1933.¹⁷

16. 54 Stat. 806, U.S.C.A., Title 15, §80a-10(b)(2). The granting of the exemption requested under Section 10(d)(2) would have automatically exempted the Bank from Section 10(b)(2).

17. These facts, although not a part of the record, are included for the Court's information.

SUMMARY OF ARGUMENT

The Securities and Exchange Commission has, pursuant to Section 6(c) of the Investment Company Act of 1940, granted the Commingled Investment Account of First National City Bank exemptions from portions of Section 10 of the Act. The National Association of Securities Dealers, Inc. seeks judicial review of the Commission's orders, contending that the Commission exceeded its authority under Section 6(c).¹⁸

The contested exemptions are of limited scope. They relate only to the composition of the Committee for the Commingled Account, which stands in the same relation to the Commingled Account for purposes of the statute as does a board of directors to an investment company that takes the corporate form. The effect of the exemptions is to permit three, instead of two, of the members of the five-man Committee to be affiliated with the Bank. The Bank made no request for exemption from the registration or reporting requirements of the Act, from the provisions prohibiting self-dealing or (except for certain temporary exemptions) from any of the other important investor protections of the statute.

Section 6(c) gives the Commission a broad dispensing power to exempt any person from any provision of the Act if the Commission finds, as it has here, that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes

18. Section 43(a) of the Act provides that only a "person or party aggrieved" by orders of the Commission may obtain judicial review of such orders. Since the orders here affect no right of the NASD or its members which is protected by the Act, and since neither the NASD nor its members will sustain direct and immediate injury, or indeed any injury, as a result of such orders, the NASD lacks standing to sue and the petition should be dismissed.

of the Act. The NASD refuses to recognize the breadth of this power. It asserts that Section 10(c) contains an "inexorable prohibition" against officers and directors of any one bank constituting a majority of the directors of an investment company. The Commission may not, the NASD argues, grant an exemption from Section 10(c) because to do so would be inconsistent with the purposes of the Act (as expressed in Section 10(c)) and therefore not within the standards of Section 6(c). To accept this line of argument would be to read Section 6(c) out of the Act, because the existence of a prohibition in the Act, which in every case under Section 6(c) is the very reason why exemption is necessary, would then also be the very reason for denying the exemption. Section 6(c) contains no qualification or limitation, express or implied, as to the sections of the Act from which exemption may be granted, and there is no basis for arguing that the Commission lacks the power to grant an exemption from Section 10(c).

The Commission has the power to exempt the Commingled Account from Section 10(c), and it has appropriately exercised that power here in accordance with the tests which the Commission has long applied in granting exemptions pursuant to Section 6(c). First, the legislative history of Section 10(c), which the NASD misreads, shows that the section was included in the Act as the result of experience with closed-end investment companies organized by banks and bank security affiliates in the 1920's. The Commingled Account bears no resemblance to these earlier investment companies and is completely insulated by banking regulation and the Act from the abuses associated with such companies.

Second, the Commingled Account is a form of investment company not possible under banking regulations in

effect in 1940 and was therefore not known to the Commission and Congress when the Act was passed. The Commingled Account thus presents a classic case for the application of Section 6(c). It is moreover a reasonable assumption that had this type of investment company been operating in 1940, it would have been completely exempted from the Act, as were the bank-operated common trust funds which the Commingled Account so closely resembles.

Finally, compliance by the Commingled Account with Section 10(c) is not necessary to accomplish the Act's objectives and policies. The participants in the Commingled Account will be adequately protected from any potential conflicts of interest which could arise as a result of the Bank's commercial banking activities by the detailed supervision and regulation of the banking authorities, by the duties and disabilities imposed upon fiduciaries by state law and by the full range of Commission regulation under both the Investment Company Act of 1940 and the Securities Act of 1933.

The NASD contends, as another reason for reversal, that the Commission was obliged to find, and not merely "assume", that the Committee for the Commingled Account would exercise the directorial duties and functions contemplated by the Act. Implicit in the Commission's assumption is a conclusion, clearly supported by the record, that the Committee members would in fact be the directors of the Commingled Account. The Committee is elected by and responsible to the participants. Moreover, the Commingled Account's constituent documents require the Committee to exercise the functions assigned to directors by the Act, including the essential function of reviewing at least annually the management agreement with the Bank.

Also implicit was the Commission's conclusion that the banking laws and regulations would not preclude the

proper exercise by the Committee of its directorial duties and responsibilities under the Act. Because the Federal Reserve Board understood that the Bank would have "effective" control of the Commingled Account, it does not follow that the Committee and the participants do not have the ultimate control required by the Act. Nor was the Commission required to be guided by the Board's characterization of the Bank and the Commingled Account as a "single entity", since the Board was resolving a different question under a different statute having a different purpose. Moreover, both the Federal Reserve Board and the Comptroller, in ruling favorably upon the proposal for the Commingled Account, specifically recognized that supervision of the Commingled Account would be in the hands of a Committee elected by the participants and that the tenure of the Bank as investment adviser would be at the mercy of the Committee and the participants. They understood this would be required by the Investment Company Act.

ARGUMENT

I.

The NASD lacks standing to seek review of the Commission's orders.

On August 26, 1966, the Bank filed in this Court its motion to dismiss the instant petition on the ground that the NASD is not a "person or party aggrieved" by the Commission's orders and thus lacks standing under Section 43(a) of the Act¹⁹ to seek judicial review. The Bank respectfully refers this Court to the motion to dismiss and the Bank's reply to the NASD's answer to the motion for the Bank's argument on this point.

19. 54 Stat. 844, as amended, U.S.C.A. Title 15, §80a-42(a).

II.

The exemptions from Section 10 of the Act were properly granted by the Commission.

The NASD asserts that the Commission has exceeded its discretionary authority under Section 6(c) of the Act by granting exemptions which are not consistent with the purposes fairly intended by the policy and provisions of the Act. In taking this position, the NASD disregards the limited extent of the exemptions which the Commission has granted, misconstrues the scope and function of Section 6(c), misreads the legislative history of Section 10(c) and therefore misunderstands the purpose of that section, and fails to accord proper significance to the other forms of regulation which the Commission's orders have left intact. In the bargain, the NASD attacks the motives and good faith of the Commission. We will deal with each of these errors as we proceed to demonstrate that the Commission properly exercised its broad discretionary powers under Section 6(c).

A. The scope of the contested exemptions is narrow.

The contested exemptions are from Sections 10(b)(2), 10(b)(3) and 10(c) of the Act. Sections 10(b)(2) and 10(b)(3) respectively provide that a majority of the directors of an investment company must be persons who are not affiliated with the principal underwriter of the investment company's securities²⁰ or with any investment banker.²¹ And Section 10(c) provides that a majority of

20. The Commission regards the Bank as the Commingled Account's statutory "principal underwriter".

21. An exemption was requested from this provision because the Bank might be deemed an "investment banker", as defined in Section 2(a)(20) of the Act, 54 Stat. 793, U.S.C.A., Title 15, §80a-2(a)(20), by reason of its participation in underwritings of U.S. Government and municipal obligations pursuant to the powers granted to national banks by paragraph Seventh of Section 5136 of the Revised Statutes, as amended, 48 Stat. 184 (1933), as amended, U.S.C.A., Title 12, §24 (¶Seventh).

the board may not be persons who are officers or directors of any one bank. These were the only exemptions of any significance requested by the Bank²² and they relate only to the composition of the Committee for the Commingled Account, which is the statutory equivalent of a board of directors.²³ The effect of the exemptions is to permit three, instead of two, of the members of a five-man Committee to be affiliated with the Bank.²⁴

No exemptions were requested from the registration and prospectus requirements of either the 1940 Act or the Securities Act of 1933, or from the requirements of the 1940 Act with respect to furnishing the Commission and the participants with periodic reports. No exemptions were requested from the provisions of the Act relating to self-dealing. Indeed, the Bank agreed to a condition broadening the scope of one of them. See JA 65. No exemptions (other than the temporary exemptions referred to in note 22, *supra*) were requested from the requirements that the participants elect the members of the Committee, approve (at least initially) the management agreement with the Bank, ratify the selection of the accountants for the Commingled Account and approve any changes in the fundamental policies of the Commingled Account. Nor were any exemptions requested from the requirements that the unaffiliated members of the Com-

22. None of the other exemptions were opposed. Three were temporary exemptions from provisions which would have required participant action before the first scheduled annual meeting of participants. The other two related to custody of assets and bonding. See JA 67-68.

23. Section 2(a)(12) of the Act, 54 Stat. 792, U.S.C.A., Title 15, §80a-2(a)(12), defines the term "director" to mean "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated".

24. The Committee's composition thus complies fully with Section 10(a) of the Act, 54 Stat. 806, U.S.C.A., Title 15, §80a-10(a), which permits no more than 60% of the directors of an investment company to be persons affiliated with the investment adviser.

mittee approve the continuance of the management agreement (unless the participants themselves do so) and the selection of accountants. These and other important investor protections under the securities laws are afforded the participants in the Commingled Account. Additional protections not afforded investors in mutual funds are also present as the result of comprehensive regulations and visitation rights of the Comptroller of the Currency.²⁵

B. The power given the Commission by Section 6(c) to grant exemptions from the Act is more than broad enough to cover the Bank's exemptions.

Congress has granted the Commission "broad dispensing powers"²⁶ in connection with the administration of the 1940 Act. Section 6(c) provides that:

"The Commission, * * * by order upon application, may conditionally or unconditionally exempt any person * * * from any provision or provisions of this title * * *, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

The breadth of the power granted by Section 6(c) is such that a former Chairman of the Commission testified before Congress in 1963 that he believed the Commission could wholly exempt a fund like the Commingled Account from the application of the 1940 Act.²⁷ The Bank, of

25. See *Government Operations Hearing* 42-45.

26. *SEC v. Variable Annuity Life Ins. Co. of America*, 359 U.S. 65, 92 (1959) (concurring opinion). See also Jaretzki, *The Investment Company Act of 1940*, 26 WASH. U.L.Q. 303, 314 n.32 (1941), where the author, who was intimately involved in the drafting of the Act, refers to Section 6(c) as "one of the most sweeping grants of power contained in the Act".

27. *Government Operations Hearing* 23 (statement of William L. Cary).

course, did not ask the Commission to exercise such plenary power. The only question here is whether the Commission acted properly in relaxing certain of the provisions of Section 10 of the Act to permit a majority of the Committee for the Commingled Account to be affiliated with the Bank.

Section 6(c) is as much a part of the Investment Company Act as Section 10. No regulatory provision of the Act establishes such a "rigid rule of conduct"²⁸ that the Commission does not have the power to waive compliance with its terms, so long as the standards of Section 6(c) are properly applied. As the Commission has stated:

"That Section, by its terms, authorizes us to exempt, with or without conditions, any person from 'any provision' of the Act. *It contains no qualifications or limitations as to the sections of the Act from which exemption may be granted.* We have consistently viewed Section 6(c) as empowering us to grant exemptions whenever, and to the extent that, the standards specified within that Section are satisfied."²⁹ (Emphasis added.)

Specifically, the Commission has for many years rejected arguments based on a literal reading of the provision from which an exemption is desired or on the purpose or policy which such a literal reading might seem to

28. The quoted phrase is from *United States v. Mississippi Valley Generating Co.*, 364 U.S. 520, 551 (1961), and is used by the NASD at p. 30 of its brief to describe the Congressional intent behind Section 10(c) of the Act. The *Mississippi Valley* case involved a criminal statute making it an offense for anyone interested in the profits of a business entity to act as an agent of the United States for the transaction of business with such entity. Neither that statute nor the Supreme Court's characterization of it has any relevance here.

29. *Investors Mutual, Inc.*, SEC Investment Co. Act Release No. 3635, p. 3 (Feb. 15, 1963).

imply. To accept such arguments would deprive Section 6(c) of any effect.³⁰

And yet it is precisely this type of argument which the NASD makes. By referring to "the flat and inexorable prohibition contained in Section 10(c)" (NASD brief, p. 17), the NASD tries to persuade this Court that nothing more is required than a literal reading of Section 10(c).³¹ This approach ignores Section 6(c). If Congress had intended that no exemptions from Section 10(c) be given, Congress would have said so. Over the years exemptions have been granted from the Act as a whole and from many of its individual sections, including portions of Section 10.³² Nothing in Section 10(c) indicates that it

30. In its Findings and Opinion in the proceeding below, the Commission quoted (at JA 60) from its earlier decision in *Transit Investment Corp.*, 28 S.E.C. 10, 17 n.20 (1948), where it was held that the

" 'purposes fairly intended by the policy and provisions' of the Act obviously means something more than a literal reading only of the provision from which an exception is desired. Otherwise, the existence of a provision prohibiting a transaction, which in every case under Section 6(c) is the very reason why an application for exemption is necessary, would also be the very reason for denying the application, thus making it impossible to resort to Section 6(c) to exempt a transaction from any provision of the Act."

31. The Supreme Court has said, "It is a familiar rule, that a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers." *Church of the Holy Trinity v. United States*, 143 U.S. 457, 459 (1892) (statute prohibiting the importation of aliens under contract to perform labor or service of any kind held not applicable to a contract by a church with an alien minister). See also *NLRB v. Fruit & Vegetable Packers & Warehousemen, Local 760*, 377 U.S. 58, 72 (1964) (statute prohibiting consumer picketing at secondary sites held not applicable to the type of consumer picketing involved, citing and quoting the *Holy Trinity* case).

32. See *Scudder, Stevens and Clark Fund, Inc.*, 26 S.E.C. 158 (1947) (exemption from Section 10(b)(2)); *Institutional Investors Mutual Fund, Inc.*, 35 S.E.C. 72 (1953) (exemption from Section 10(a)); *National Securities Series*, SEC Investment Co. Act Release No. 4356 (Sept. 15, 1965) (exemption from Sections 10(a) and 10(b)(2)).

is more sacrosanct than the other provisions of the Act. The argument (at p. 22 of the NASD brief) that Section 10(c) has remained inviolate for more than twenty-five years proves only that no exemption from the provision had been requested prior to the Bank's application; it does not prove that the Commission is without the power to grant such an exemption.³³

The NASD also refers (at p. 22 & n.46 of its brief) to the recent statement by the Chairman of the Commission that

"the proper way to resolve questions as to the application of the Investment Company Act to these [commingled managing agency] accounts, is to seek an accommodation which will preserve the essential protections of the Investment Company Act while at the same time reconciling this objective with the patterns and needs of bank regulation."³⁴

The NASD maintains that the Commission lacks power to effect such an accommodation, but it does not say why this is so.

The Act itself was born in a spirit of accommodation or "compromise", as the NASD recognizes. See NASD brief, p. 8 n.13. The Act contains many accommodations to types of companies and to practices which existed in 1940. In fact, the grandfather clause contained in Section 10(c) is an accommodation to existing bank-sponsored

33. In June 1965, before the Bank's application had been filed, the Chairman of the Commission testified before Congress that although Section 10(c) might restrict the operations of an investment company which was also a bank holding company, the Commission would have power to grant exemption from that provision if it found that such exemption met the standards of Section 6(c). *Hearings on H.R. 7372 Before the Subcommittee on Domestic Finance of the House Committee on Banking and Currency and the House Committee on Banking and Currency*, 89th Cong., 1st Sess. 22 (1965).

34. *Hearings on S. 2704 Before a Subcommittee of the Senate Committee on Banking and Currency*, 89th Cong., 2d Sess. 137 (1966).

funds. Given its power under Section 6(c), surely the Commission has the power to work an accommodation in the administration of the Act that might well have been worked out in 1940 had bank commingled agency funds been in existence.³⁵

The NASD would have this Court believe that in granting the exemptions requested by the Bank the Commission ignored the standards and legislative history of Section 6(c) and the Commission's own earlier interpretations of the scope of the section. But in fact, it is the NASD which ignores the Commission's careful delineation, in its Findings and Opinion, of its authority under Section 6(c):³⁶

35. The Commission has on other occasions accommodated the Act to banking or insurance regulation when in its view the accommodation could be made without loss of essential investor protections. For example, in *Savings Bank Investment Fund*, 24 S.E.C. 531 (1946), the Commission granted an investment company extensive exemptions from the Act. One of the arguments which the Commission found persuasive was that "the supervisory powers of the State Commissioner of Banks will assure to the investor-banks sufficient safeguards to justify the exemptions requested." 24 S.E.C. at 537. See also *Institutional Investors Mutual Fund, Inc.*, 35 S.E.C. 72 (1953). Similarly, in *Variable Annuity Life Ins. Co. of America*, 39 S.E.C. 680 (1960), the Commission granted exemptions from various provisions of the Act to a registered investment company issuing variable annuity and life insurance contracts, partly on the basis of supervision of the company by insurance authorities.

36. The NASD cites only three cases in the section of its brief (pp. 30-33) dealing with Section 6(c). Two of these, *Variable Annuity Life Ins. Co. of America*, 39 S.E.C. 680 (1960), and *Prudential Ins. Co. of America*, SEC Investment Co. Act Release No. 3620 (Jan. 22, 1963), *aff'd*, 326 F.2d 383 (3d Cir.), *cert. denied*, 377 U.S. 953 (1964), were cited by the Commission in discussing its powers under Section 6(c). In the *Valic* case, the Commission in fact granted seven out of ten requested exemptions. In the *Prudential* case, the exemptions requested were much more extensive than those requested by the Bank and the Commission found that to grant them would be the equivalent of a total exemption from the Act. SEC Investment Co. Act Release No. 3620, p. 15. The third case, *American Trucking Ass'n v. United States*, I.C.C., 364 U.S. 1 (1960) is completely inapposite. There, the Supreme Court directed that a motor carrier permit case be remanded to the Interstate Commerce Commission because the ICC had failed to follow standards established in its own prior decisions and approved by the Supreme Court. That is not the case here.

"We have held that the propriety of granting an exemption pursuant to Section 6(c) of the Act 'largely depends upon the purposes of the section from which an exemption is requested, the evils against which it is directed, and the end which it seeks to accomplish.' Section 6(c) was put into the Act for the purpose, among others, of permitting the exemption of persons 'who are not within the intent of the proposed legislation * * *' [citing Sen. Rep. No. 1775 (76th Cong., 3rd Sess.) at p. 13] even though such persons come within the scope of the Act by virtue of its specific provisions * * *. This was to take care of special situations that might have been overlooked or that could not be foreseen at the time the legislation was drafted.' In such situations the showing required in order to meet the public interest and related standards set forth in Section 6(c) is that the compliance from which exemption is sought is not necessary to accomplish the Act's objectives and policies." JA 59-60. (Footnotes omitted; bracketed material in original.)

We submit that this is an accurate statement of the scope of Section 6(c) and that the Commission properly applied these standards to the Bank's exemption application.

C. The Commission's action in exempting the Commingled Account from Section 10(c) was consistent with the statutory standards governing the exercise of the Commission's exemptive power.

The Bank's application for exemption from Section 10(c) meets all the tests which the Commission has long applied in granting exemptions pursuant to Section 6(c). First, the evils against which Section 10(c) was directed have no relevancy to the Commingled Account. Second, the Commingled Account is not within the intent of that section and constitutes a special situation that was not foreseen in 1940. Finally, compliance by the Commingled

Account with Section 10(c) is not necessary to accomplish the Act's objectives and policies.

1. Section 10(c) was directed at abuses associated with closed-end investment companies totally unlike the Commingled Account.

The nature of the evils at which Section 10(c) was directed can be derived from the legislative history. The picture which the NASD presents of the 1940 Senate and House hearings³⁷ on the bills which led to the 1940 Act is distorted. And the NASD never takes the trouble to analyze the specific nature of the bank-sponsored investment companies that were mentioned or to ask whether the abuses disclosed at that time are relevant to the Commingled Account.

The NASD's assertion that Section 10(c) was "carefully considered and hammered out" in the course of the Congressional hearings (NASD brief, p. 17) is simply not borne out by the legislative history. The real "hammering out" of the Investment Company Act was not done by Congress and it was not done at the legislative hearings. The Act was hammered out by the Commission and its staff working with representatives of the industry in order to arrive at a compromise bill acceptable to both groups. The fact that Section 10(c) ended up as it began shows how little, if any, attention it received at this crucial stage.

The original bill³⁸ was drafted by the Commission. Section 10(a)(1) of the bill³⁹ provided that the majority of

37. *Hearings on S. 3580 Before a Subcommittee of the Senate Committee on Banking and Currency*, 76th Cong., 3d Sess. (1940) [hereinafter cited as *Senate Hearings*]; *Hearings on H.R. 10065 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce*, 76th Cong., 3d Sess. (1940) [hereinafter cited as *House Hearings*].

38. S. 3580 and H.R. 8935, 76th Cong., 3d Sess. (1940).

39. The text of Section 10 of S. 3580 is set forth at *Senate Hearings* 8-9.

the board of directors of an investment company could not consist of members affiliated with any one company. The restriction was not limited to banks. At the same time, Section 10(b)(2) of the bill permitted existing interlocks with banks to continue notwithstanding subsection (a). In combined effect, these two provisions were essentially the same as Section 10(c) of the Act as it is today.

The bill was first considered by Congress at the Senate hearings. Commissioner Healy and members of the staff outlined the bill for seven days.⁴⁰ The presentation with respect to Section 10⁴¹ contained references to investment companies connected with commercial banks and investment banking firms, and the types of abuses described were essentially the same in both cases. Section 10(a) of the bill was mentioned only briefly; the example used to illustrate the purpose of the provision did not involve a bank.⁴² Section 10(b)(2) was not mentioned at all.

Representatives of the industry were then heard. They objected to many provisions of the bill, and also presented their views as to the proper scope of investment company regulation.⁴³ Although Section 10 of the bill was discussed extensively by the industry representatives,⁴⁴ little attention was paid to the provisions dealing with commercial banks. Only two industry representatives commented directly on Sections 10(a)(1) and 10(b)(2) of the bill, and their comments are not particularly enlightening.⁴⁵

40. *Id.* at 32-323.

41. *Id.* at 207-23.

42. *Id.* at 214-15.

43. *Id.* at 325-764.

44. See, e.g., *id.* at 329, 411-21, 457-58, 476-77, 485, 493-94, 510-11, 542-44, 557-59, 572-79, 643-46, 651-59, 702-09.

45. One witness referred to the grandfather clause in Section 10(b)(2) of the bill as "a most illogical exception to an illogical rule." *Id.* at 644. The other, chief spokesman for the open-end funds, said that he did "not recall that any evidence has been offered as to any

At the conclusion of the industry statements, the Commission gave further testimony before the Senate Subcommittee.⁴⁶ The only significant reference during this part of the hearings to Sections 10(a)(1) and 10(b)(2) of the bill as applied to banks was made by David Schenker, the Commission's Chief Counsel for its Investment Trust Study, in rebuttal to the industry statements referred to above. Mr. Schenker rejected the arguments that the grandfather clause in Section 10(b)(2) of the bill evidenced a lack of concern with bank-sponsored investment companies. He indicated that, although the "interlocking relationship between investment companies and banks was a very unhealthy relationship, both from the point of view of the bank and from the point of view of the investment trust", there were only "one or two such situations which are still left" and the status quo was not being disturbed "because of the delicate relationship between banks and investment companies".⁴⁷

When the Senate hearings were about to conclude, an industry spokesman presented proposals for the framework of an investment company bill that would be acceptable to the industry.⁴⁸ Thereafter, the Commission and industry representatives worked together to draft a

abuse arising out of this situation." He also thought that the inclusion of the grandfather clause indicated that "the drafters of this bill were not much concerned about this possible conflict". *Id.* at 659.

One other industry representative spoke briefly about Section 10 (d)(2) of the bill, which related to service by a bank director or officer as an "investment officer or manager" of an investment company (and not, as the witness seemed to believe, as a director). *Id.* at 573. He passed over Section 10(b) by saying that it related to "a special and limited type of situation with which we are not concerned." *Id.* at 572.

46. *Id.* at 783-1051.

47. *Id.* at 885-86.

48. *Id.* at 1052-59.

memorandum summarizing the principles of a compromise bill.⁴⁹ That memorandum proposed a complete substitute for Section 10 as originally introduced, but made no reference whatever to the provisions which are now found in Section 10(c) of the Act.⁵⁰ When the revised bill⁵¹ was drafted, Section 10(c) was included in the form in which we know it today. As already pointed out, there was no substantive change in the provisions of Sections 10(a)(1) and 10(b)(2) of the original bill as applied to banks.

Only one inference is possible from this history: although many of the provisions of the Investment Company Act are the result of careful hammering out, Section 10(c) is not.⁵² Even David Schenker, in summarizing the revised bill to the Senate Subcommittee, did not bother to refer to Section 10(c), although he spelled out in some detail the changes which had been made in Section 10 and specifically noted the new provisions relating to affiliations with investment advisers, brokers, investment bankers and principal underwriters.⁵³

49. See *House Hearings* 62-63, 96-100.

50. *Id.* at 97.

51. S. 4180 and H.R. 10065, 76th Cong., 3d Sess. (1940).

52. If Section 10(c) is as "precise and unambiguous" as the NASD claims at p. 12 of its brief, then it follows that the section permits a majority of the board of an investment company to be composed of employees (other than officers and directors) of a bank, since a board composed of "employees" of one bank is not specifically prohibited by the section. An investment company having a majority of its board made up of employees of a bank would seem to be more completely bank dominated than an investment company having a majority of its board composed of directors of a bank (other than employees). Such bank directors might be quite independent of the bank in comparison with persons employed by it. This being the case, the section can hardly be described both as "precise and unambiguous" and as designed to outlaw an investment company which is an arm or department of a bank (NASD brief, p. 19).

53. See *Senate Hearings* 1113.

The only statement in the course of the hearings which sheds much light on Section 10(c) is the statement made by David Schenker during the House hearings after the compromise bill had been worked out with the industry:

"Subsection (c) [of Section 10] * * * was inserted not only on the basis of our study, but after conferences with the Federal Reserve Board. There were very undesirable consequences flowing from interlocking directorships or interlocking relationships between commercial banks and investment companies. Some of the worst examples of abuses we had in the whole study arose out of that relationship and the Federal Reserve Board, as well as ourselves, felt that in the future, there should not be that close relationship. The adversities of the investment trust may have harmful effects on the bank such as runs on the bank. They are so intimately tied up.

"Subsection (c) provides that hereafter the majority of the board of directors of an investment company cannot consist of directors of any one bank; but we permit, in order not to disturb the status quo, the present relationships to continue."⁵⁴

This statement makes clear that one of the purposes of the provision was to protect banks, an aim which is unrelated to the policy and purposes set forth in Section 1(b) of the Act.⁵⁵ It is not for the Commission to concern itself with that aspect of Section 10(c), particularly where, as here, the Federal Reserve Board has already ruled that Section 32 of the Banking Act of 1933⁵⁶ will not be violated by service of Bank officers on the Committee for the Commingled Account.⁵⁷

54. *House Hearings* 110-11.

55. 54 Stat. 790, U.S.C.A., Title 15, §80a-1(b).

56. Act of June 16, 1933, 48 Stat. 194, as amended, 49 Stat. 709 (1935), U.S.C.A., Title 12, §78.

57. 12 C.F.R. §218.111 (Supp. 1966).

The other purpose of Section 10(c) was, of course, to protect against the abuses disclosed in the Commission's study of investment trusts and investment companies which had preceded the drafting of legislation.⁵⁸ The study showed that, during the 1920's, many banks organized security affiliates which had identity of ownership and management with the banks, but which were separately incorporated under state law and were therefore able, unlike the banks, to engage freely in the investment banking business. Some of the investment companies organized during this period as affiliates of banks were essentially security affiliates, primarily engaged in long-term capital financing, underwriting and other investment banking operations, but also engaged in some investment company activities such as buying and selling securities for investment or speculative purposes. In other cases, the security affiliates evolved into, or sponsored, investment companies.⁵⁹ All of the 21 "management investment companies proper" which at the end of 1929 had been sponsored by commercial banks and trust companies or bank affiliates (presumably security affiliates engaged in investment banking) were of the closed-end type.⁶⁰

58. The results of this comprehensive study were embodied in the Commission's *Report on Investment Trusts and Investment Companies*, in five parts. Reference will be made to the first three: (I) *The Nature, Classification, and Origins of Investment Trusts and Investment Companies*, H.R. Doc. No. 707, 75th Cong., 3d Sess. (1938) [hereinafter cited as *First Report*]; (II) *Statistical Survey of Investment Trusts and Investment Companies*, H.R. Doc. No. 70, 76th Cong., 1st Sess. (1939) [hereinafter cited as *Second Report*]; (III) *Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies*, cc. 1-6, H.R. Doc. No. 279, 76th Cong., 1st Sess. (1939-1940), c. 7, H.R. Doc. No. 136, 77th Cong., 1st Sess. (1941) [hereinafter cited as *Third Report*]. The Commission also published six supplemental reports on special subjects, including one entitled *Report on Commingled or Common Trust Funds Administered by Banks and Trust Companies*, H.R. Doc. No. 476, 76th Cong., 2d Sess. (1939) [hereinafter cited as *Common Trust Fund Report*].

59. *First Report* 38, 93-95.

60. *Second Report* 57, 124.

The abuses and deficiencies in the organization and operation of investment companies affiliated with banks were substantially the same as those disclosed with respect to many closed-end investment companies sponsored by investment bankers.⁶¹ In a typical case, the security affiliate retained control of the investment company through a relatively small investment in its voting stock. The security affiliate also headed the selling syndicate which profited from underwriting the initial public offering of investment company shares and borrowed from the investment company itself part of the funds needed to pay for the shares it was offering to the public. Thereafter, the investment company was used to support the market for the bank's capital stock and to purchase other securities in which the sponsors had a pecuniary interest, including securities of doubtful value.⁶²

These then were the abuses at which Section 10(c) was directed: loans of investment company funds to the sponsors, purchases of bank stock and use of the investment company to absorb securities in which the sponsors had an interest. These details are practically ignored by the NASD. Presumably the NASD recognizes that the Com-

61. Compare *Third Report*, c. 2, at 115-81, with *id.*, c. 7, at 2486-87. Most investment companies sponsored by investment bankers in the late 1920's were of the closed-end type. See *Second Report* 57, 124. Closed-end companies have less need for a portfolio of marketable securities than open-end companies because shareholders in closed-end companies have no right of redemption. See *First Report* 26-27. The sponsors were thus able to place non-marketable security issues in the portfolio of the investment company and then make an offer to the public of the more salable shares of the investment company. The liquid resources of the investment company could also be utilized to make loans to, and to acquire securities underwritten by, the sponsor, or to take over blocks of securities in which the capital of such sponsor might have become too heavily involved. See *First Report* 76-77.

62. See *Third Report*, c. 2, at 115-42.

mingled Account is not comparable to the bank-affiliated investment companies studied by the Commission in the 1930's. Many of these earlier companies were formed to avoid banking regulation.⁶³ The Commingled Account, on the other hand, conforms to and is responsive to banking regulation. And the Commingled Account is completely insulated from the abuses associated with such companies by banking regulation and the Act.⁶⁴

2. **The Commingled Account is a type of investment company which was unknown in 1940, and it is a reasonable assumption that, had the Commingled Account been known, it would have been completely exempted from the Act as are the common trust funds which it so closely resembles.**

Exemptions pursuant to Section 6(c) are regarded as particularly appropriate where the company seeking exemption is of a type not known to Congress or the

63. See *Hearings Pursuant to S. Res. 71 Before a Subcommittee of the Senate Committee on Banking and Currency*, 71st Cong., 3d Sess. 1052 (1931). To the extent that a bank security affiliate operated as an investment company, it did so, of course, in order to carry on for the account of the bank's stockholders (who were also the affiliate's stockholders) a business in which the bank itself could not engage directly, i.e., the making of an investment profit from holdings in stocks and speculative securities. In contrast to such an investment company, the Commingled Account is formed as a service, and a fiduciary service at that, to the Bank's customers, and only they will derive any investment profit from Commingled Account transactions.

64. See, e.g., draft prospectus for the Commingled Account ("funds in the Commingled Account will not be lent to others"), JA 16; draft management agreement ("in connection with purchases or sales of securities for the Commingled Account, neither the Bank nor any of its directors, officers or employees will act as a principal or agent or receive any commissions"), JA 34; Section 9.12 of Regulation 9 of the Comptroller of the Currency, 12 C.F.R. §9.12 (Supp. 1966); Sections 8(b)(1)(G), 10(f), 12(d)(3), 17(a), 17(d), 21 of the Act, 15 Stat. 804, 807, 809, 815, 816, 822, U.S.C.A., Title 15, §§80a-8(b)(1)(G), -10(f), -12(b)(3), -17(a), -17(d), -21; SEC Rule 2a-3 under the Act, 17 C.F.R. §270.2a-3 (1964).

industry at the time of the passage of the Act.⁶⁵ Knowing this, the NASD argued that the Commingled Account is a bank-dominated fund and therefore within the class of funds known to Congress and forbidden by Section 10(c). This approach is too superficial. The closed-end investment companies at which Section 10(c) was directed were not the only type of "bank-dominated" investment vehicles known to the Commission and Congress in 1940. There was another type and it received complete exemption from the Act.

Commencing in 1927, a number of banks had developed various types of commingled or common trust funds which, in the Commission's view, constituted "a class of investment vehicle akin to an investment company of the management type."⁶⁶ Participation in common trust funds was found to be typically limited to trust estates of which the sponsor bank was trustee, but the Commission recognized that in many instances this relationship was established by means of revocable trusts entered into specifically for the purpose of participating in the common trust fund.⁶⁷ The Commission also noted that common trust funds presented a possible means by which banks could economically provide small trust estates with diversification,⁶⁸ that the provisions of the governing trust indentures were "similar to the indenture provisions of management investment companies of the

65. See *Senate Hearings* 197, 872 (statements of David Schenker and Commissioner Healy). These statements are quoted in part by the NASD at p. 31 of its brief.

66. *First Report* 2. Common trust funds were listed as one of the five major types of investment companies for the purpose of statistical analysis. *Second Report* 6, 25.

67. *Common Trust Fund Report* 8. Further details with respect to a number of the common trust funds referred to in the *Common Trust Fund Report* are given in Saxon & Miller, *Common Trust Funds*, 53 GEO. L.J. 994, 997-1000, 1003, 1011-15 (1965).

68. *Common Trust Fund Report* 3.

Massachusetts or common law trust type"⁶⁹ and that "the managements of the trust company and the common trust fund are interlocked, with complete management control over the assets of the trust fund vested in the sponsoring institution."⁷⁰

Even though common trust funds were recognized as an investment vehicle akin to management investment companies, they were exempted from the Act by Section 3(c)(3).⁷¹ No explicit statement was made in either the Senate or House hearings setting forth the reason for this exemption, but it can be inferred from statements in the Commission's *First Report* that there were two principal considerations: (1) there was no general public distribution of participations in common trust funds; and (2) the funds were subject to the supervision and control of bank regulatory authorities.⁷²

69. *Id.* at 7.

70. *Id.* at 10. During the Senate hearings an industry representative noted the similarity of common trust funds to the investment companies sponsored by investment counsel:

"Trusts that are operated by investment counsel firms are typical examples of cases where investors want continuing management by a particular group of individuals. Some of these trusts operated by investment counsel firms have been organized as true trusts in order to assure this. Another well-known type is the 'common trust fund.' These are operated by banks and are expressly exempt from this proposed act.

* * *

"* * * Neither can a change in trusteeship be brought about by the beneficiaries of a common trust fund, which is a special kind of open-end investment company operated by banks and recognized under both Federal and State statutes. This same principle is also well established in the investment counsel field. In dictating by law, for the protection of investors against the people they employ to manage their investments, why differentiate between any of these examples?"

Senate Hearings 502-03.

71. 54 Stat. 798, U.S.C.A., Title 15, §80a-3(c)(3).

72. See *First Report* 33-34, 63. Banks themselves were also exempted by Section 3(c)(3), and by definition, see Section 2(a)(5), 54 Stat. 791, U.S.C.A., Title 15, §80a-2(a)(5), an institution can be a "bank" only if it "is supervised and examined by State or

Although the Commission has taken the position that collective investment funds for managing agency accounts, such as the Commingled Account, are not common trust funds exempted from the Act by Section 3(c)(3), certainly the Commingled Account is much closer in structure and purpose to such common trust funds than it is to the closed-end investment companies at which Section 10(c) was directed.⁷³ The restrictions on advertising and publicity, the limitations on transferability of participations in the Commingled Account and the underlying fiduciary relationship between the customer and the Bank required for admission to the Commingled Account all point to the fact that the Commingled Account is a lineal descendant of the common trust funds and is not the offspring of the closed-end investment companies. Accordingly, it is reasonable to assume that had collective funds such as the Commingled Account been in operation at the time of the adoption of the Act, they would have received exemption from the Act as a whole. Certainly, the granting to the Commingled Account of a narrow exemption which preserves virtually intact the entire

Federal authority having supervision over banks". See also the exchange of correspondence, at *Senate Hearings* 925-29, between the Board of Governors of the Federal Reserve System and the Commission relating to the exemption for bank holding company affiliates in Section 3(c)(4) of the Act, 54 Stat. 798, U.S.C.A., Title 15, §80a-3(c)(4). The Board contended that such holding company affiliates should be exempted "since these companies are subject to examination and supervision by the Reserve Board." *Senate Hearings* 927.

73. We have never argued, as the NASD suggests at pp. 24-25 of its brief, that Section 10(c) is by its terms applicable only to closed-end investment companies. If the Commingled Account were not within the literal scope of Section 10(c), there would have been no need to request an exemption. What we do argue is that the abuses at which the section was directed were associated with closed-end investment companies having no resemblance to the Commingled Account and that a proper exercise of the exemptive power under Section 6(c) permits, even requires, recognition of this fact.

structure of regulation imposed by the Act cannot seriously be considered inconsistent with the Act's purposes and policies.⁷⁴

3. The potential conflicts of interest which have been attributed to bank-sponsored collective investment funds are adequately regulated in the case of the Commingled Account.

In considering the propriety of exempting the Commingled Account from Section 10(c), the Commission quite correctly found that compliance with that section was not necessary to accomplish the Act's objectives and policies, that is, the protection of the participants in the Commingled Account from potential conflicts of interest which could arise as a result of the Bank's commercial banking activities.

The potential conflicts which were cited by Chairman Cary and the safeguards against such conflicts are fully discussed in the Commission's Opinion and Findings (JA 61-63). There is no need to repeat them here. However, certain matters raised by the NASD require comment.

The NASD quotes Chairman Cary's list of potential conflicts in full, but fails to note that Chairman Cary was discussing the general question of whether bank commingled agency accounts should be wholly exempt from the securities laws. The potential conflicts Chairman Cary referred to were those that might be involved in the case of a hypothetical bank-sponsored fund not subject to Investment Company Act regulation. He was saying that most if not all mutual funds have areas of potential conflict of interest and that the requirements of the Act for

74. Section 10(c) was not even mentioned by Chairman Cary when he described the protections to investors in bank collective investment funds that would result from registration under the Act. See *Government Operations Hearing* 3-32.

an unaffiliated group of directors—"or in the case of no load funds, one unaffiliated director"—provide a degree of protection.⁷⁵ But here the Commingled Account is registered under the Act and offers to the participants all of the protections mentioned by Chairman Cary.⁷⁶

The NASD also attempts to disparage the protection afforded by banking supervision by quoting from the Commission's decision: "banking oversight is of course not the same in scope or orientation as the protective provisions of the Act * * *." NASD brief, p. 26. The NASD did not take the trouble to quote the entire sentence and it omitted the preceding sentence completely. What the Commission said was—

"The Account, unlike the bank-sponsored investment companies with which Congress was concerned in enacting Section 10(c), is regarded by the banking authorities as one aspect of the Bank's fiduciary functions and as such will be subject to the supervision and regulation of those authorities. While banking oversight is of course not the same in scope or orientation as the protective provisions of the Act, it will provide participants in the Account with additional protections not afforded investors in other investment companies." JA 62.

It must be borne in mind that the rights of customers of the Bank to whom the Bank has a fiduciary responsibility, such as the participants in the Commingled Account, are superior to those of the Bank's depositors and shareholders. Any activity which creates rights of surcharge in or other liabilities to such customers is therefore of great concern to the banking authorities.⁷⁷

75. *Id.* at 11.

76. Compare *id.* at 9-13 with pp. 13-14, *supra*.

77. See Comptroller's Manual 21.

Finally, the NASD, by indirection, attempts to minimize the safeguards which the Commission found in the fact that the Bank has fiduciary responsibilities to each participant. The NASD brushes this finding aside by saying that, "we assume that by the reference to the fiduciary responsibilities of the Bank as managing agent, the Commission did not mean that these responsibilities are any greater than those deemed applicable by the Commission in any investment company relationship." NASD brief, p. 26.

The NASD nowhere specifies the responsibilities which arise out of the typical investment company relationship. In the case of the Commingled Account, these responsibilities are clear. The Bank has a direct fiduciary relationship with each participating customer by reason of the agreement signed by the customer authorizing the Bank to invest his funds, together with the funds of other customers who have given the Bank the same authority, in the Commingled Account. Because the customers' funds are to be commingled, the customer gives up his right to control the Bank individually and agrees that the participants as a group and the Committee may exercise such control. But this does not affect the fiduciary duties of care and loyalty that the Bank, as agent, owes to the customer, as principal.⁷⁸

A shareholder in an ordinary mutual fund does not enter into a relationship of principal and agent with the fund or with the fund's investment adviser. The shareholder has, in fact, no direct relationship with the adviser. If he has any rights against the adviser, they derive from his status as a shareholder and can be enforced only by the fund itself.⁷⁹

78. See RESTATEMENT (SECOND), AGENCY §§379, 387, 425 (1958).

79. Section 36 of the Act, 54 Stat. 841, U.S.C.A., Title 15, §80a-35, authorizes the Commission to bring an action to enjoin, on the ground of gross misconduct or gross abuse of trust, an officer, director

The Wharton School Study has suggested that one type of approach to the problem of potential conflicts of interest on the part of investment company management

“* * * would be to eliminate the [investment company] shell and require a direct relationship between shareholders and controlling managers. This could be brought about either by requiring each open-end company to be internally managed (i.e., excluding investment advisers), or by eliminating the investment company shell between the adviser and shareholder by requiring advisers to sell shares directly in a fund explicitly managed and controlled by them. This type of approach might provide a closer alignment of power and fiduciary responsibility * * *.”⁸⁰

It is precisely this type of “closer alignment of power and fiduciary responsibility” which results from the direct fiduciary relationship between the Commingled Account participant and the Bank as the participant’s managing agent, and which the Commission properly took into account in considering the Bank’s exemption application.

D. The exemptions from Section 10(b) of the Act were also properly granted.

The type of abuse at which Section 10(b)(3) was directed has already been touched upon in the discussion of Section 10(c). It must be obvious that the conflicts of interest, if any, that might arise out of the relationship between the Commingled Account and the Bank as an “investment banker” are of a very different degree from the potential conflicts existing between typical investment companies and investment banking houses.

or investment adviser or any investment company from acting in such capacity. This test, however, is less rigorous than the standard of due care which governs the relationship of an agent to his principal. See *Senate Hearings* 262.

80. Wharton School Study 35.

In the first place, there is virtually no potential for an adverse effect on the participants in the Commingled Account as a result of the Bank's underwriting activities. The only securities which the Bank is permitted to underwrite are "public securities" which are thought to possess investment characteristics making them suitable for unlimited investment by national banks themselves.⁸¹

In any event, there is no opportunity for self-dealing by the Bank even in the limited area in which the Bank is permitted to engage in underwriting. Any such transaction involving the Commingled Account would be subject to the various prohibitions imposed by the 1940 Act.⁸² In addition, the regulations of the Comptroller of the Currency prohibit purchases of securities where there may be a conflict of interest.⁸³ Investments presenting questions of conflict of interest, self-dealing, divided loyalty and other improper relationships are subject to the constant scrutiny of the Comptroller's Representatives in Trusts who regularly examine the

81. See Revised Statutes, Section 5136, para. Seventh, as amended, 48 Stat. 184 (1933), as amended, U.S.C.A., Title 12, §24 (¶Seventh). There are also a few obligations which national banks may underwrite subject to limitations on the amount which may be held.

82. Section 10(f) of the Act, 54 Stat. 807, U.S.C.A., Title 15, §80a-10(f), prohibits the Commingled Account from acquiring, during the existence of any underwriting syndicate, any security for which the Bank is acting as a principal underwriter. The Bank has also agreed to a condition imposed by the Commission extending the duration of the prohibition of Section 10(f) under circumstances where a syndicate has been terminated while its members still have unsold allotments. JA 65, 72-73. Section 17(a) of the Act, 54 Stat. 815, U.S.C.A., Title 15, §80a-17(a), prohibits the Commingled Account from acquiring any security from the Bank itself, whether or not an underwriting syndicate is still in existence, and Section 17(d) of the Act, 54 Stat. 816, U.S.C.A., Title 15, §70a-17(d), prohibits the Commingled Account and the Bank from participating in any joint enterprise without the Commission's approval.

83. See Section 9.12(a) of Regulation 9, 12 C.F.R. §9.12(a) (Supp. 1966).

operations of the Bank's Trust and Investment Division.⁸⁴ The Representatives are instructed to give special consideration to transactions involving the investment of assets of fiduciary accounts in stock or obligations of, or property acquired from, organizations in which there exists such an interest on the part of a bank as might affect the exercise of the best judgment of the bank in its fiduciary capacity, and to determine whether the bank as a fiduciary has purchased bonds from a member of a syndicate in which the bank is participating.⁸⁵

Section 10(b)(2) was directed at possible conflicts of interest arising out of the principal underwriter's pecuniary interest in the sales commissions it would derive from the sale of the investment company's securities.⁸⁶ There is of course no sales commission or "load" charged in connection with admission to the Commingled Account. Moreover, because of the fiduciary relationship between the Bank and its customers, the Bank must, in giving advice concerning the Commingled Account, act solely as investment adviser for such customer with disclosure of its position with respect to the Commingled Account. See JA 34. The exemption from this provision was thus clearly proper.

E. The Commission has acted in the public interest and consistently with the protection of investors and the purposes of the Act; its orders should be affirmed.

Nothing in the NASD's briefs reflects more pointedly the weakness of its case than its efforts to impugn the

84. National banks are examined at least three times in every two years. See Revised Statutes, Section 5240, as amended, 70 Stat. 124 (1956), U.S.C.A., Title 12, §481. Section 9.11(d) of Regulation 9, 12 C.F.R. §9.11(d) (Supp. 1966), provides for the examination of investments held in fiduciary accounts, including collective investment funds.

85. See Comptroller's Manual 87-93.

86. See *House Hearings* 110.

motives and good faith of the Commission. The contention in the brief on the merits that the Commission was acting simply to "avoid a legislative contest" (NASD brief, p. 22) becomes, in the brief answering the Bank's motion to dismiss, an accusation that the Commission was "motivated by expediency rather than statutory policy" (NASD brief on motion, pp. 2-3).

The Commission has found, as it must under Section 6(c), that the exemptions granted the Commingled Account are "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act. There is ample support for this in the sponsorship and characteristics of the Commingled Account: the financial stability and long history of investment experience of the sponsoring institution; the fact that the Bank exercises investment responsibility or gives investment advice in respect of accounts having aggregate assets of more than \$8.5 billion; the extensive experience of the Bank in the operation of common trust funds; the availability of this experience for the first time to the smaller investor; the low relative cost of these services to the participants; the absence of a sales load; and the successive layers of regulation imposed respectively by banking authorities, the common law applicable to fiduciaries and the laws administered by the Securities and Exchange Commission. Did the Commission need any other motive than the desire to make these advantages available to a segment of the investing public?

The Commission's orders must in any event be affirmed unless this Court has been persuaded that the public interest, the protection of investors and the purposes fairly intended by the Act cannot be served by the Bank's Commingled Account. The record in the case offers no support whatsoever for such a conclusion. The rhetoric of the NASD brief is no substitute. The words

of the Supreme Court in *Gray v. Powell*, 314 U. S. 402, 411-12 (1941), are particularly pertinent:

"In a matter left specifically by Congress to the determination of an administrative body, as the question of exemption was here * * *, the function of review placed upon the courts * * * is fully performed when they determine that there has been a fair hearing, with notice and an opportunity to present the circumstances and arguments to the decisive body, and an application of the statute in a just and reasoned manner. * * *

"Such a determination as is here involved belongs to the usual administrative routine. Congress, which could have legislated specifically as to the individual exemptions * * *, found it more efficient to delegate that function to those whose experience in a particular field gave promise of a better informed, more equitable, adjustment of the conflicting interests * * *.

"Where, as here, a determination has been left to an administrative body, this delegation will be respected and the administrative conclusion left untouched."

III.

The Commission properly assumed that the Committee members will discharge the directorial responsibilities contemplated by the Act.

The NASD contended before the Commission that the true directors of the Commingled Account would be the directors of the Bank rather than the Committee members and that the participants in the Commingled Account would therefore be denied the voting rights provided by Sections 16(a) and 18(i).⁸⁷ The matter was fully briefed

87. Section 18(i) of the Act, 54 Stat. 821, U.S.C.A., Title 15, §80a-18(i), provides that every share of stock of a registered investment company "shall be a voting stock". Section 16(a) of the Act, 54 Stat. 813, U.S.C.A., Title 15, §80a-16(a), provides that no person shall serve as a director of a registered investment company unless elected by the shareholders.

before the Commission and discussed on oral argument. In its Findings and Opinion, the Commission disposed of the question by saying that, "it is assumed that the Committee or its members will discharge their responsibilities as directors, or persons performing similar functions, under the securities acts or otherwise."⁸⁸ JA 58 n.11.

The NASD now contends before this Court that the Commission was obliged to find, and not merely assume, that the Committee would be "vested with" and "exercise" the directorial duties and functions contemplated by the Act before it could grant the exemptions under Section 10. NASD brief, pp. 7, 35.

On the question of whether the Committee would discharge (or "exercise") its directorial responsibilities, the Commission could do no more than make an assumption because such a question can only be determined after the fact. How could the Commission make a finding as to the discharge of such responsibilities by persons who at the time of the application had not even been appointed? Since the Bank had not requested exemption from either Section 16(a) or Section 18(i), the Commission quite properly assumed that the law would be obeyed and the Committee members would discharge their responsibilities as directors.

Implicit in this assumption, of course, was the Commission's conclusion that the Committee members would in fact be the directors of the Commingled Account and "vested with" the duties and responsibilities of directors contemplated by the Act. Also implicit was the conclusion that the banking laws and regulations referred to by the NASD would not preclude the proper exercise of such duties and responsibilities. Both conclusions are clearly supported by the record. In contrast, the NASD's argument is constructed on a series of unwarranted and unsupported assertions.

88. The NASD also filed a petition for rehearing (JA 75) addressed to this issue, which was denied by the Commission (JA 77).

The NASD first maintains that "the Committee will as a practical matter abdicate in the investment supervisory area." NASD brief, p. 34 n.69. This amounts to an assertion that the members of the Committee will violate the law and yet the NASD cannot adduce in support of this assertion a single provision of the prospectus for the Commingled Account or of the management agreement. The NASD (in the footnote just referred to) quotes the prospectus to the effect that the "Bank is responsible for the management of the investments in the Commingled Account" and that "the Bank will determine what securities are to be purchased or sold for the Commingled Account and will execute transactions for the Commingled Account accordingly." But, as the NASD well knows, the Bank's investment function derives from the management agreement with the Committee representing the participants. As stated in the prospectus, the Bank's management activities as investment adviser are carried out "pursuant to" a management agreement. JA 24.

Moreover, as the NASD concedes in the very next sentence of the same footnote, its position cannot be premised on the fact that the Bank will make portfolio selections. The power to manage investments is a legitimate function of an investment adviser and is specifically provided for in the Act.⁸⁹ Nor can the NASD be suggesting that the

89. Section 2(a)(19) of the Act, 54 Stat. 793, U.S.C.A., Title 15, §80a-2(a)(19), provides that the term "investment adviser" of an investment company means "any person * * * who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company * * *." (Emphasis added.)

As one commentator has pointed out, "the true management type of contract is specifically recognized * * * by the Investment Company Act. Recently there has been a tendency towards this type of contract which in many cases would seem to conform more realistically to the fact." Jaretzki, *Duties and Responsibilities of Directors of Mutual Funds*, 29 LAW & CONTEMP. PROB. 777, 782 (1964).

Committee must exercise daily supervision over the investments of the Commingled Account. The directors of many mutual funds delegate active management of the portfolio either to an investment adviser or to officers of the investment company and exercise only a general supervision over the purchase and sale of the portfolio securities.⁹⁰

The NASD next complains, in the same footnote, that its "efforts to elicit facts as to the nature of the Committee's 'supervision', which is nowhere described, were rebuffed by the Commission." Those "efforts" consisted of a singular motion seeking to require the Commission "to amend, modify, supplement or amplify" its Notice of Filing of Application to "state matters contained in the brief" of the Bank below and to "relate those matters" to a statement contained in the Bank's application. If the NASD wants facts, it has only to refer to the prospectus and management agreement. Throughout both documents are provisions which require the exercise by the Committee of the functions expressly assigned to directors by the 1940 Act. Among these is the obligation, pursuant to Section 15(a)(2) of the Act,⁹¹ to pass upon the continuance of the management agreement or to put the matter before the participants for their con-

90. See Wharton School Study 49-50:

"The active management of the portfolio of open-end investment companies typically is delegated to an investment adviser, or to one or several principal officers of the investment company, who are usually also affiliated with the adviser." (Footnote omitted.)

See also Jaretzki, *Duties and Responsibilities of Directors of Mutual Funds*, 29 LAW & CONTEMP. PROB. 777, 784 (1964):

"It is not the duty of the board itself specifically to select each individual security for purchase or sale. It is sufficient if the directors are satisfied that purchases and sales are competently handled either by the officers of the company or by the investment adviser under whatever general directions they may wish to impose and pursuant to the objectives of the fund and the limitations to which it is subject."

91. 54 Stat. 812, U.S.C.A., Title 15, §80a-15(a)(2).

sideration (JA 25, 35). The Committee also has the power to terminate the management agreement (JA 25, 35) pursuant to Section 15(a)(3) of the Act.⁹² In order to exercise these and other responsibilities⁹³ effectively, as well as to insure that the Bank adheres to the Commingled Account's stated investment policy and investment restrictions, the Committee must, of course, review the Bank's performance as an investment adviser. For this reason the management agreement provides that "all transactions of purchase or sale for the Commingled Account shall be promptly reported to the Committee by the Bank" (JA 32). The power to terminate the management agreement necessarily includes the power to force

92. 54 Stat. 812, U.S.C.A., Title 15, §80a-15(a)(3).

93. The Committee has many other responsibilities which derive from the provisions of the 1940 Act and which require supervision of the Commingled Account, such as: pursuant to Section 2(a)(39), 54 Stat. 796, U.S.C.A., Title 15, §80a-2(a)(39), responsibility to determine the fair value of any assets of the Commingled Account for which market quotations are not readily available (JA 19); pursuant to Section 19, 54 Stat. 821, U.S.C.A., Title 15, §80a-19, responsibility to declare cash distributions from the investment income and realized capital gains of the Commingled Account and to report to participants as to the source of such payments (JA 23-24); pursuant to Section 20(a), 54 Stat. 822, U.S.C.A., Title 15, §80a-20(a), responsibility to insure that the solicitation of proxies complies with the rules and regulations of the Commission (JA 26); pursuant to Section 30, 54 Stat. 836, U.S.C.A., Title 15, §80a-29, responsibility for the reports required by law to be filed with the Commission and transmitted to the participants (JA 28); and pursuant to Section 32(a), 54 Stat. 838, U.S.C.A., Title 15, §80a-31(a), responsibility to select the independent public accountant for the Commingled Account (JA 28). Implicit in Section 10 of the Act, 54 Stat. 806, U.S.C.A., Title 15, §80a-10, is the responsibility of the Committee, and particularly the unaffiliated members, to oversee the operation of the Commingled Account to insure that conflicts of interest, if any, are resolved in favor of the participants. The Committee members are also responsible for the accuracy of, and required to sign, the Commingled Account's registration statement under the Securities Act of 1933. See Sections 6(a) and 11(a) of that Act, 48 Stat. 78, 82, as amended, U.S.C.A., Title 15, §§77f(a), 77k(a).

changes in the Bank's performance of its duties under such agreement.⁹⁴

The Committee will not, because it may not, "abdicate" in the investment supervisory area. Its responsibilities with respect to the management agreement are real and substantial. If the Committee members fail to exercise honestly and independently their responsibilities under the Act, they would be subject to an action under Section 36 of the Act⁹⁵ for removal or suspension from office and liable to suit by the participants.⁹⁶ In the face of these facts, the NASD's assertion (at p. 34 of its brief) that "the board of directors of the Bank, not the Committee, will in fact be entrusted with the directorial functions of the Account" is irresponsible.

Since the NASD can find no evidence in the Bank's application to the Commission that the Committee will not be vested with directorial responsibilities, it has to resort to a misinterpretation of banking laws and regulations. These laws and regulations, according to the NASD, will preclude the Committee members from exercising their duties as directors. The Commission properly rejected this argument, and pointed out that its assumption that

94. The Commission's opposition to H.R. 7482, 87th Cong., 1st Sess. (1961), which is discussed by the NASD at note 68 on p. 33 of its brief, is not relevant. All actions or recommendations of the committee contemplated by that bill would have been subject to the veto or approval of the insurance company's board of directors. In contrast, the Committee for the Commingled Account may act on the management agreement and supervise the Bank's performance of its functions thereunder without seeking the approval of the Bank's board of directors.

95. 54 Stat. 841, U.S.C.A., Title 15, §80a-35.

96. See *Brown v. Bullock*, 294 F.2d 415, 421 (2d Cir. 1961):

"We think §15(a) * * * laid down a requirement of annual approval not merely formal but substantial, the minimum content of which is a matter of federal law; hence a complaint alleging failure to conform to that requirement sets forth a federal claim."

the Committee would discharge its responsibilities under the securities acts or otherwise served as a clear indication that in its opinion the banking laws and regulations did not preclude the exercise of such responsibilities. JA 79.

The NASD attempts to make much of the Federal Reserve Board's view that the Commingled Account would be operated under the "effective control" of the Bank.⁹⁷ Assuming that the Federal Reserve Board's characterization is accurate, it still does not follow that the Committee for the Commingled Account has any less control than is required by the Investment Company Act. Ultimate control of the Commingled Account in fact resides in the Committee and the participants and nowhere else. No special circumstances are present here. Other investment companies also have a majority of their boards composed of persons affiliated with the investment adviser.⁹⁸ If the Commingled Account is under the effective control of the Bank, so are such other investment companies under the effective control of their investment advisers. Yet the NASD would not contend that the boards of directors and shareholders of such investment companies do not have ultimate control.

The case of an individual managing agency account where the Bank has been given complete investment discretion as to the investment and reinvestment of the assets in the account can be taken to demonstrate the point. The Bank has "effective" control over the assets for so long as it continues to have investment discretion. Indeed, the customer's motive in establishing the account is to give

97. 12 C.F.R. §218.111(b) (Supp. 1966).

98. David Schenker stated during the House hearings that Section 10(a) of the Act, 54 Stat. 806, U.S.C.A., Title 15, §80a-10(a), was designed to give the investment adviser "the right to impose his investment advice" on the investment company, since the stockholders are buying and want the investment advice of a particular person. *House Hearings* 109-10. (Emphasis added.)

the Bank control of such a nature that the customer is relieved of the burden of managing his own assets. Yet the customer has ultimate control. This analysis applies equally to the Commingled Account, except that the participants, having consented to the commingling of their assets, agree that their individual powers of control shall be exercised by a majority vote at meetings of participants or by the Committee as their elected representatives. Since the Federal Reserve Board understood that the Committee, as the representative of the participants, would supervise the operation of the Commingled Account and would possess, with the participants, the power to terminate the management agreement with the Bank,⁹⁹ there is no reason to suppose that the Board failed to understand that ultimate control, subject to the will of a majority of the participants, would reside with the Committee.

Nor can any support for the NASD's argument be derived from the Board's statements that the Bank and the Commingled Account "would constitute a single entity *for the purposes of section 32*" (emphasis added) and that, for the same purposes, the Commingled Account "would be regarded as nothing more than an arm or department"¹⁰⁰ of the Bank. These statements are clearly characterizations made by the Board in connection with the specific question before it—the applicability of Section 32 of the Banking Act of 1933¹⁰¹ to the service of Bank officers on the Committee. The Board was confronted with the question whether such bank officers would have, by reason of such service, a conflicting outside interest to promote to the detriment of the participants. In

99. See 12 C.F.R. §§218.111(e)-(f) (Supp. 1966).

100. 12 C.F.R. §218.111(j) (Supp. 1966).

101. Act of June 16, 1933, 48 Stat. 194, as amended, 49 Stat. 709 (1935), U.S.C.A., Title 12, §78.

answer to this question, the Board concluded that the Bank and the Commingled Account would constitute a single entity, so that no significant outside interest could develop. The Board itself recognized that the question before it was not the same as the question before the Commission and that in the Commission's view the Commingled Account and the Bank were separate entities.¹⁰²

The NASD also misinterprets the effect of the Comptroller's regulations in an attempt to find support for its contention that the participants will be denied their voting rights under the Act. The NASD assumes, first, that the Committee is a committee responsible to the board of directors of the Bank by reason of Section 9.7 (a)(1) of Regulation 9,¹⁰³ and second, that the Bank would have the "exclusive management" of the Commingled Account as ordinarily required in the case of bank collective investment funds by Section 9.18(b)(12) of the Regulation.¹⁰⁴

The Comptroller's letter of May 10, 1965 (JA 47) approving the proposed arrangement for the Commingled Account pursuant to Section 9.18(c)(5) of Regulation 9¹⁰⁵ shows that the Comptroller, like the Federal Reserve Board, specifically recognized that supervision of the Commingled Account would be in the hands of a Committee elected by the participants (and therefore not a Bank committee to which Section 9.7(a)(1) would be

102. See Federal Reserve Board memorandum, dated Dec. 15, 1965, reprinted in *Hearings on S. 2704 Before a Subcommittee of the Senate Committee on Banking and Currency*, 89th Cong., 2d Sess. 581, 584-85 (1966).

103. 12 C.F.R. §9.7(a)(1) (Supp. 1966).

104. 12 C.F.R. §9.18(b)(12) (Supp. 1966).

105. 12 C.F.R. §9.18(c)(5) (Supp. 1966).

applicable)¹⁰⁶ and that the Bank would be responsible for the management of the investments of the Commingled Account pursuant to a management agreement with the Committee. The letter shows also that the Comptroller recognized that the management agreement would have to be approved by the participants at their first annual meeting and could be continued in effect only with the approval of the unaffiliated members of the Committee or the participants. The letter expressly states that the Commingled Account "does not comply with certain provisions of Section 9.18(b) of the Regulation." JA 51. One such provision was necessarily the requirement of Section 9.18(b)(12) with respect to exclusive management.

The Commission's treatment of the NASD's argument based upon the Federal Reserve Board ruling and the Comptroller's regulations was more than adequate to satisfy Section 8(b) of the Administrative Procedure

106. Section 9.7(a)(1) of Regulation 9 authorizes the Bank's board of directors to utilize committees in the administration of the Bank's fiduciary powers. Such committees are appointed by and responsible to the board. The Committee for the Commingled Account, on the other hand, represents and is responsible to the participants, not the Bank, and the members of the Committee will depend upon election by the participants at their annual meetings for continuance in office. The Committee for the Commingled Account is therefore not a committee of the Bank to which Section 9.7(a)(1) is applicable.

Section 9.7(a)(1) committees of course have their place in the management of the Commingled Account for so long as the Bank is retained as investment adviser, just as is the case with other investment advisory customers of the Bank. The Bank will function through such committees in accepting the fiduciary responsibility initially assumed as managing agent for the customer and in furnishing investment management for the Commingled Account pursuant to the management agreement with the Committee.

From the fact that the Comptroller permits non-bank personnel to serve on committees conforming to Section 9.7(a)(1) it does not follow that every committee with non-bank members is such a committee.

Act.¹⁰⁷ That provision requires only that an agency deal with "material" issues. See *Minneapolis & St. L. Ry. v. United States*, 361 U. S. 173, 193-94 (1959). It is not necessary to discuss at length every contention, however far fetched.¹⁰⁸

CONCLUSION

For the foregoing reasons, this Court should enter its order either dismissing the petition for review or affirming the orders of the Securities and Exchange Commission.

Respectfully submitted,

SAMUEL E. GATES,
320 Park Avenue,
New York, New York 10022,

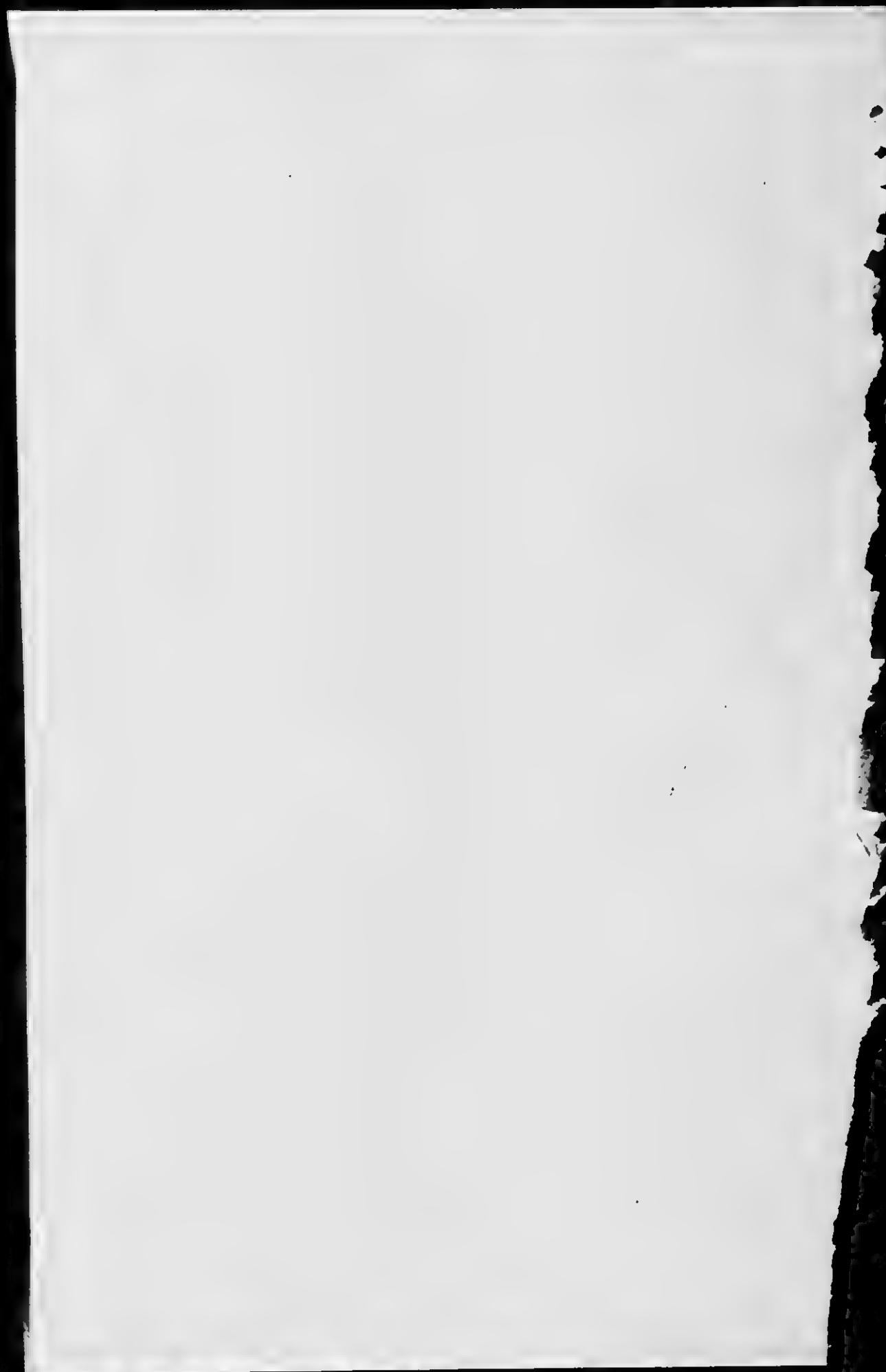
STEPHEN AILES,
1250 Connecticut Avenue,
Washington, D. C. 20036,
Attorneys for Intervenor.

DEBEVOISE, PLIMPTON, LYONS & GATES,
STEPTOE & JOHNSON,
Of Counsel,

Dated: October 24, 1966.

107. Act of June 11, 1946, 60 Stat. 242, U.S.C.A., Title 5, §1007(b).

108. In any event, this Court must disregard the objection based upon Section 8(b) of the Administrative Procedure Act as it was not urged before the Commission, although the NASD had full opportunity to do so in its petition for rehearing. See Section 43(a) of the Act, 54 Stat. 844, as amended, U.S.C.A., Title 15, §80a-42(a).



REPLY BRIEF FOR PETITIONER

IN THE
United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 20,164

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent,*
FIRST NATIONAL CITY BANK, *Intervenor*

On Petition To Review an Order of the
Securities and Exchange Commission

United States Court of Appeals
for the District of Columbia Circuit

FILED NOV 22 1966

Nathan J. Paulson
CLERK

MARC A. WHITE

General Counsel

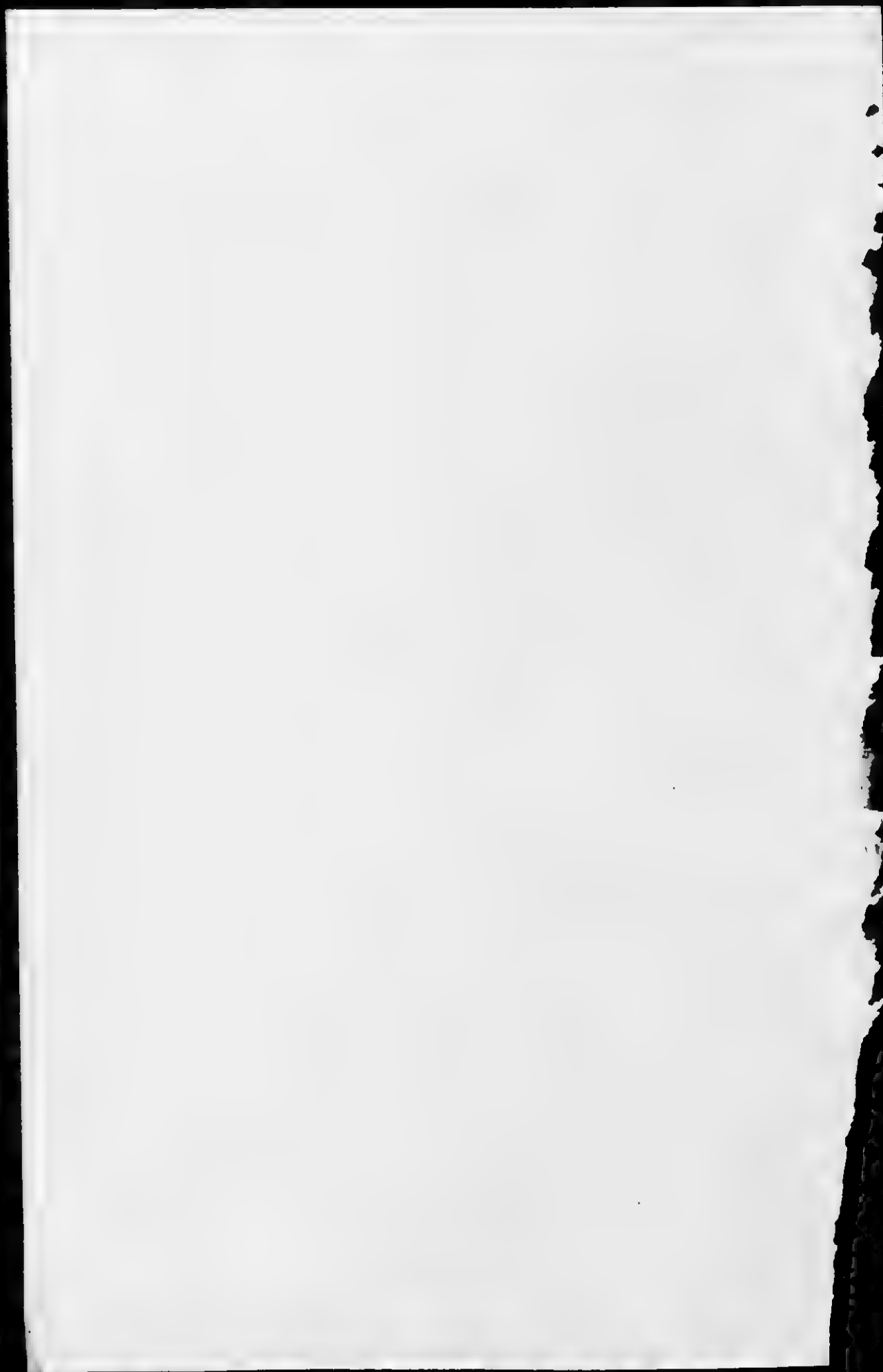
National Association of
Securities Dealers, Inc.
888 - 17th Street, N. W.
Washington, D. C. 20006

JOSEPH B. LEVIN

BROWN LUND & LEVIN
1625 Eye Street, N. W.
Washington, D. C. 20006

Attorneys for Petitioner





INDEX

	Page
1. Section 10(c) of the Investment Company Act	1
2. The Committee	12

CITATIONS

CASES:

<i>Aldred Investment Trust v. S.E.C.</i> , 151 F. 2d 254 (C.A. 1, 1945)	8
<i>Brown v. Bullock</i> , 194 F. Supp. 207 (S.D.N.Y., 1961), affirmed 294 F. 2d 415 (C.A. 2, 1961)	7, 8
<i>Federal Reserve System v. Agnew</i> , 329 U.S. 441 (1947)	10
<i>Fundamental Investors</i> , Investment Company Act Re- lease No. 3596 (December 27, 1962)	1
<i>Imperial Financial Services</i> , Investment Company Act Release No. 7684 (August 26, 1965)	13
<i>Institutional Investors Mutual Fund</i> , 35 S.E.C. 72 (1953)	9
<i>Insured Accounts Fund</i> , 38 S.E.C. 123	9
<i>Petroleum and Trading Corporation</i> , 11 S.E.C. 389 (1942)	9
<i>Prudential Insurance Company of America</i> , Investment Company Act Release No. 3620 (January 22, 1963), affirmed 326 F. 2d 383 (C.A. 3, 1964), cert. denied 377 U.S. 953	7
<i>Savings Bank Investment Fund</i> , 24 S.E.C. 531 (1946) .	9
<i>S.E.C. v. Chenery Corp.</i> , 318 U.S. 80 (1943)	10

STATUTES:

Investment Company Act of 1940, Act of August 22, 1940, c. 686, 54 Stat. 789, et seq., U.S.C.A., Title 15, § 80a-1 et seq.	
Section 2(a) (15), 54 Stat. 790, U.S.C.A., Title 15, § 80a-2(a) (15)	6
Section 10(c), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(c)	passim

	Page
Section 10(h), 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(h)	6
Section 14(a), 54 Stat. 811, U.S.C.A., Title 15, § 80a-14	12
Section 31(b), 54 Stat. 838, U.S.C.A., Title 15, § 80a-30(b)	8
Section 36, 54 Stat. 841, U.S.C.A., Title 15, § 80a-35	8
Section 37, 54 Stat. 841, U.S.C.A., Title 15, § 80a-36	8
Section 42(e), 54 Stat. 842, U.S.C.A., Title 15, § 80a-41(e)	8
Section 49, 54 Stat. 846, U.S.C.A., Title 15, § 80a-48	8

MISCELLANEOUS:

Hearings before a Subcommittee of the Committee on Banking and Currency, U. S. Senate, on S. 3580, 76th Cong., 3d Sess.	3, 8, 12
Hearings before a Subcommittee of the Committee on Interstate and Foreign Commerce, House of Rep- resentatives, on H. R. 10065, 76th Cong., 3d Sess.	6
Senate Report No. 1775, 76th Cong., 3d Sess.	5, 6, 8

IN THE
United States Court of Appeals
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 20,164

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent,*
FIRST NATIONAL CITY BANK, *Intervenor*

On Petition To Review an Order of the
Securities and Exchange Commission

REPLY BRIEF FOR PETITIONER

1. Section 10(c) of The Investment Company Act

The brief of the Securities and Exchange Commission ("the Commission"), and the brief of First National City Bank ("the Bank") even more so, labor irrelevancies in our opinion. The Commission's major premise is refuted by the statute itself, as we shall show. Significantly, the

Commission never urges, nor could it, that the Section 10(c) prophylaxis would not serve a useful and beneficial purpose here to protect against the acknowledged potential conflicts of interest. It is as though observance of Section 10(c) of the Act would result in too much investor protection so that the Commission finds it necessary, in the cause of the public interest and the protection of investors, to dilute the statutory package of investor safeguards. In the Commission's view, other items "provide substantial safeguards" (Br. p. 17). The Commission is very careful not to characterize them as equivalent safeguards. The Commission is simply substituting its judgment for the policy of the statute as to what is necessary adequately to protect investors in the circumstances. And let there be no mistake that at issue is an essential protection of the statute. Section 10 is, as the Commission has recently characterized it, a "keystone provision of the statute."¹

It should be emphasized that where as here a bank is the very management of the investment company, with a free rein in the conduct of its operations, the conflicts of interest problem, the evil that is the concern of Section 10(c), emerges probably as sharply as it ever could. For example, at oral argument, one of the Commissioners (not the Commissioner who dissented) referred to Section 17(d) of the Act, which as implemented by the Commission's rules prohibits so-called joint transactions unless approved by the Commission.² He observed that the Bank's application presented "in a very exaggerated or extreme form" the problem of

"the old matter of the joint ventures or seeming joint ventures, where the bank on the one hand and in the exercise of its various functions as a bank, has relationships with a company and your [A]ccount, for

¹ *Fundamental Investors*, Investment Company Act Release No. 3596, p. 5 (December 27, 1962).

² See our main brief, p. 9.

various reasons, also has relationships with a company, and who is to say where the propriety line should be drawn and is drawn. * * * I am not suggesting impropriety. I think this could happen, you know, with the best of intentions."³

This is precisely the target of the Section 10(c) prophylaxis. Section 10(c) is, as Professor Dodd characterized it, a "double-barreled protection"⁴ and supplements the specific self-dealing prohibitions and enforcement provisions of the statute, including periodic examinations by the Commission, as discussed below.

By 1940, there remained only one or two bank dominated investment companies⁵ and, because of the delicate relationships involved, the existing situations were left untouched under the grandfather clause of Section 10(c).⁶ What is it then that the Congress, on the Commission's recommendation, sought to accomplish prospectively? Is the language of Section 10(c), which embraces *all* investment companies, intended or inadvertent? The statute and legislative history, in our opinion, when fairly read, permit of but one conclusion: that the Congress intended to and did act broadly, and we should add with foresight, as is evidenced by the potential conflicts of interest that exist here.

As discussed in our main brief (pp. 11-16), the Commission's study had disclosed a history of gross abuse by commercial bankers. The conflicts of interest problem was considered "more acute" in the case of the commercial banker.⁷ The conclusion reached by the Commission and

³ Transcript of oral argument, pp. 67-68.

⁴ See our main brief, p. 27.

⁵ Senate hearings, p. 886.

⁶ See our main brief, p. 13, note 26.

⁷ Commissioner Healy stated: "In many instances the abuses are more subtle but just as injurious to the investor. The public's funds are used to further the banking business of the insiders . . ." Senate Hearings, p. 37.

the Congress was that if a bank-investment company interlock was to be permitted, the protection of investors at a *minimum* required the prophylaxis in Section 10(c). The question was not how little, but rather how much, should be done to restrict this interlock, and indeed whether the interlock should be permitted at all. Commercial bankers it will be recalled had urged total segregation in light of their sorry experience of the twenties.

The Commission agrees (Br. p. 24, note 36) that the statute was intended to apply to open-end, as well as closed-end, investment companies.⁸ But the Commission then asserts that the Account is not the "type" of open-end company to which Section 10(c) is directed. This approach to the statute presupposes a legislative intention, for which there is not a shred of support, that the statutory prophylaxis should be applied selectively; that there was an intended discrimination—only certain, but not all, investors exposed to the conflicts of interest problem in the bank-investment company interlock were to enjoy a protection prescribed by the statute to cope with this very problem.

Our position, the Commission points out (Br. p. 23) "overlooks the fact that the evils uncovered by the Commission's study related to security affiliates, investment vehicles much different from the Account." Under the Commission's approach the securities affiliates of banks in the twenties become the frame of reference and criterion for determining the application of Section 10(c).⁹

⁸ The two types of companies are distinguishable only in the redeemability feature of their securities. This certainly is a fatuous distinction on which to turn the application of Section 10, as the Bank urges.

⁹ If the Commission means to intimate (Br. p. 23) that Section 10(c) comes into play only if an attempt is being made to circumvent the banking laws, why then did it not deem it necessary to consider the issue of the legality of the Account under the banking laws. (JA 57) This would have been a relevant and critical issue.

Reliance on the historical narrative about securities affiliates in the Commission's study to restrict the scope of Section 10(c) is misplaced. This narrative does no more than relate the origins of the bank-investment company interlock that produced the "[f]lagrant instances of self-dealing" (JA 61) which brought the Commission and the Congress to the realization that it was a relationship demanding remedial action. It was the existence of the potential for abuse in this relationship—without regard to any particular type of investment company or form of overreaching—that was the concern of the Commission and the Congress. Is it to be said, as is here in effect being urged, that the Congress was any less concerned if overreaching and abuse thereafter resulted from transactions that took a form different than those in the twenties, or if the imposition thereafter manifested itself in a particular genre of investment company? The purpose, and the statute was so enacted, was to protect *all* investment companies from commercial bankers who would impose and would "advance their own pecuniary interests at the expense of the investment companies and their security holders."¹⁰

This breadth of purpose is manifest not only in the language of Section 10(c), but in the meticulous manner in which the statute otherwise applies the Section 10(c) policy. The statute patently rejects the Commission's "securities affiliates" theory of limitation.

Thus, Section 10(h) of the Act deals with unincorporated management investment companies, including open-end companies, which do not have a board of directors. They were not the bank "securities affiliates" described in the Commission's study, the touchstone of the Commission's instant approach to the application of Section 10(c). Nevertheless, the statute specifically imposes the Section 10(c) prophylaxis on these companies. Section 10(h) provides that Section 10(c) shall apply to the board of di-

¹⁰ Senate Report p. 7. See our main brief, pp. 12-13.

rectors of the investment adviser and depositor (or sponsor) of such an unincorporated investment company.¹¹ Again, Section 10(d) of the Act relaxes certain restrictions of Section 10, but not the prohibition of Section 10(c), for certain open-end investment companies meeting specific statutory conditions.¹² These companies were not bank "securities affiliates", but so-called "no load" companies managed by investment counsel.¹³ But these companies were also subjected to Section 10(c). In addition, Section 10(c) was made applicable not only to management companies, of which closed-end and open-end companies are subclassifications,¹⁴ but also to the completely unrelated face amount certificate companies.¹⁵ These companies also were not bank "securities affiliates". Nevertheless their investors were also to enjoy the Section 10(c) protection. All this the Commission conveniently ignores and leaves unexplained as it spins its theory of statutory

¹¹ Section 10(h) of the Act, 54 Stat. 806, U.S.C.A., Title 15, § 80a-10(h) provides in pertinent part:

"In the case of a registered management company which is an unincorporated company not having a board of directors, the provisions of this section shall apply as follows:

- (1) the provisions of subsection (a) . . . shall apply to the board of directors of the depositor of such company; (2) the provisions of subsections (b) and (c) . . . shall apply to the board of directors of the depositor and of every investment adviser of such company; and (3) the provisions of subsection (f) shall apply to purchases and other acquisitions for the account of such company of securities a principal underwriter of which is the depositor or an investment adviser of such company, or an affiliated person of such depositor or investment adviser.

¹² See our main brief, p. 25.

¹³ House hearings, p. 111.

¹⁴ See p. 3, note 8 of our main brief.

¹⁵ Face-amount installment certificates, defined in Section 2(a)(15) of the Act, 54 Stat. 790, U.S.C.A., Title 15, § 80a-2(a)(15), are "in essence, unsecured obligations to pay a specified amount to the holder at a specified future date provided the purchaser makes all the payments required by these contracts." Senate Report, p. 10.

contraction. It accords the same treatment to the extensive legislative history that we cited.¹⁶

In brief, the policy of Section 10(c) was intended to be pervasive. It was to apply to all investment companies—whether or not they were management companies, whether they were management companies of the open-end or closed-end type, and whatever their organizational form or sponsorship. All companies were to be insulated from domination by a single bank and exposure to abuse from the potential conflicts of interest in that relationship.

In this connection the Commission proceeds from an incorrect premise when it argues (Br. pp. 20-21) that since the Account “was not authorized in 1940, the new proposal came within a type of situation where Congress expected the Commission to exercise its authority under Section 6(c).” As we have pointed out, when the Congress enacted Section 10(c) it was acting prospectively to prevent the creation of a relationship that had proven itself a source of abuse and was seeded with potential conflicts of interest. The fact that this relationship manifests itself in an investment company vehicle which became permissible only after 1940 is irrelevant.¹⁷ This does

¹⁶ The Bank's effort to find comfort in the fact that the statute reflected a compromise is answered by the Commission's brief in *Brown v. Bullock*, 294 F. 2d 415 (C.A. 2, 1961), a case here cited by the Commission. Speaking of the “compromise”, the Commission stated (at p. 22 of that brief): “While there was [sic] differences [by the industry] with the Commission as to the scope of that regulation, there was unanimity in the area here involved, and the compromise did not affect the basic pattern of the Act. The statute was to protect investors from selfish management . . .”

¹⁷ The Bank's efforts (Br. pp. 27-30) to look to the statutory exemption for common trust funds has been rejected by the Commission, as we pointed out in our main brief (p. 30). Contrary to the Bank's assertions, the Commission has stated that Congress “rested this exemption on the special considerations that the funds were used for bona fide fiduciary purposes rather than as a medium for general public investment and had only a limited impact in the investment fund picture”. *Prudential Insurance Company of America*, Investment Company Act Release No. 3620, p. 11 (January 22, 1963), affirmed 326 F. 2d 383 (C.A. 3, 1964), cert. denied, 377 U.S. 953. The foregoing quoted language was adopted by the Court of Appeals, 326 F. 2d at 358.

not make it any less the undesired relationship which the Congress had prohibited.¹⁸

Although the Commission professes not to be reading Section 10(c) out of the statute, its rationale and its application in effect produce that result.

As we pointed out in our main brief (p. 9), the statute specifically prohibits self-dealing. Next, the statute imposes fiduciary responsibilities on the management of investment companies.¹⁹ Further, investment companies are subject to periodic inspections by the Commission under Section 31(b) of the Act,²⁰ a matter to which the Commission makes not even a reference. "The purpose" of these Commission inspections, as Commissioner Healy explained, "is to make these companies subject to the same type of examination as national banks . . ." ²¹ In addition, the statute provides for injunctive action by the Commission and also for criminal prosecution.²²

¹⁸ The presence of the Section 6(c) authority to exempt from any section of the statute does not mean that Congress contemplated that it would necessarily ever be appropriate to invoke the authority with respect to Section 10(c). And the question here is not whether the Commission ever could, but whether it may when the very evil to which Section 10(c) is directed, potential conflicts of interest, is admittedly present.

¹⁹ The Commission does not dispute the view expressed in our main brief (p. 26) that the Bank's fiduciary responsibilities as a managing agent under the Comptroller's regulations are not any greater than those deemed applicable by the Commission in any investment company relationship. See *Brown v. Bullock*, 194 F. Supp. 207, 238-240, 244-245 (S.D.N.Y., 1961) for a discussion of fiduciary duties under the statute, which reflects the Commission's approach. See also *Aldred Investment Trust v. S.E.C.*, 151 F. 2d 254 (C.A. 1, 1945).

Commissioner Healy testified: "The fiduciary obligation of the management to stockholders is too often violated or disregarded. The bill undertakes to impose specific conditions which will insure the observance of this fundamental obligation." Senate Hearings, p. 46. This "... legislation will serve the most salutary purpose of protecting small investors from breaches of trust." Senate Report, p. 12.

²⁰ 54 Stat. 838, U.S.C.A., Title 15, § 80a-30(b).

²¹ Senate Hearings, p. 304. Under its current practice, inspections by the Commission are not as frequent as bank examinations.

²² Sections 36, 37, 42(e) and 49 of the Act, 54 Stat. 841, 842, U.S.C.A., Title 15, § 80a-35, 36, 41(e) and 48.

But this formidable arsenal was not enough to contend with the conflicts problem in the commercial bank interlock. The Section 10(c) prohibition was imposed.

All this the Commission ignores. In effect, it dismisses Section 10(c). The Commission's reliance on undertakings of the Bank not to overreach and the fact that the relationships will be policed by Comptroller's examinations and that abuses will be in violation of law, misses the point of Section 10(c). It is a prophylaxis.²³ As the

²³ The Commission recognized that this is the purpose of Section 10 in its decision in *Petroleum and Trading Corporation*, quoted in our main brief (p. 10). There the Commission denied an exemption from Sections 10(a) and 10(b) of the Act because, as the Commission put it, "conceivably" a conflict of interest might develop; mere possibility was enough to foreclose an exemption. Of significance also is the fact that the possibility which concerned the Commission was a transaction that could only have been effected in violation of the self-dealing prohibitions in Section 17 of the Act. But this was no reason to deny the "double-barreled" protection provided by Section 10. As the Bank points out (Br. p. 42, note 93), albeit in another connection, under Section 10 it is the responsibility, particularly of unaffiliated directors, "to insure that conflicts of interest, if any, are resolved in favor of the participants." (Emphasis added)

Even in the present case, where it could the Commission tried to be true to its traditional standards. In dealing with Section 10(b)(3) it stated: "We do not think there is any basis for concern that the Bank, *qua* investment banker, can or will use the Account to its advantage . . ." (J.A. 65). The Commission, of course, did not, for it could not, reach this conclusion about the Bank, *qua* commercial banker. Nor did the Commission even conclude that in its judgment the potential conflicts it had commented upon were the only ones it could foresee. In this connection, we note both the Commission's and the Bank's silence as to the possibility of the investment company being used as a "bird dog" to attract commercial banking business (See our main brief, p. 28). Since there was no evidentiary hearing there was no full exploration of the conflicts problem. As the proponent for an exemption, the burden was on the Bank to make the requisite showing. The only ground advanced by the Bank in its application to support its request was that "[u]nless an exemption from Section 10(c) of the Act is granted, the Bank will be effectively precluded from" going forward. (JA 10).

In *Insured Accounts Fund*, 38 S.E.C. 123, 127 (1957), the Commission distinguished *Savings Bank Investment Fund*, 24 S.E.C. 531 (1946) and *Institutional Investors Mutual Fund*, 35 S.E.C. 72, (1953), cited by the Bank, by stating: "In those cases . . . aside from the fact that the investment companies involved were subject to regulation by State banking authorities . . . there were no potential conflicts of interest . . ." (Emphasis added).

Court pointed out in *Federal Reserve System v. Agnew*, 329 U.S. 441, 449 (1947), in affirming the removal of a bank director under a provision in the banking laws that prohibits interlocks between commercial and investment banking:

"Section 32 is not concerned, of course, with any showing that the director in question has in fact been derelict in his duties or has in any way breached his fiduciary obligation to the bank. It is a preventive or prophylactic measure. The fact that respondents have been scrupulous in their relationships to the bank is therefore immaterial."²⁴

That the Commission gives no heed to Section 10(c) and also misunderstands its role under Section 6(c) is evident when it seeks to justify its action by stating (Br. p. 26) that it "concluded that under all the circumstances of the case the independent check on management provided for in Section 10(a) of the Act, that is, a board of directors 40% of the members of which were unaffiliated with the Bank, would adequately protect investors where management acted in conflicts of interest situations." The Commission, without authority, is substituting its judgment for that of the Congress. The Congress concluded that the bank-investment company interlock was so susceptible of abuse that the independent check provided by Section 10(a) is not enough to "adequately protect investors where management acted in conflicts of interest situations." In these circumstances, the independent check or "watchdog" provided by Section 10(c) is necessary. The Commission has no alternative but to honor and enforce this Congressional judgment. The Commission, in the face of the statutory policy and direction, mistakenly approaches the matter as if it were vested with some form of

²⁴ In *S.E.C. v. Chenery Corp.*, 318 U.S. 80, 92 (1943) the Court stated: "Abuse of corporate position, influence, and access to information may raise questions so subtle that the law can deal with them effectively only by prohibitions not concerned with the fairness of a particular transaction."

general discretion to determine the number of unaffiliated directors that are adequate to safeguard the investor.²⁵

In connection with the matter of investor safeguards, we did not, as the Commission suggests, miss any point about the significance of the Comptroller's supervision. The Commission acknowledges (Br. p. 26) "that such supervision is not a substitute for the protection afforded investors by the Investment Company Act." Yet it is relied upon for abandoning the Section 10(c) protection. It is asserted to be an "additional safeguard" (Br. p. 26) even though, as the Commission put it, "banking oversight is of course not the same in scope or orientation as the protective provisions of the Act . . . (JA 62). Moreover, the "additional safeguard" consists simply in "federal regulation by another agency of the Government"; this "is a basis for lessening the necessity for strictly applying certain of the provisions of Section 10 of the Act . . ." (Br. p. 26). But, if this is so, why did the Commission refuse the exemption from Section 10(a)? Does Section 10(c) enjoy an inferior status as an investor protection? The answer is, of course, as we pointed out in our main brief (p. 20), that the Commission honored the statutory requirements only insofar as they would not jeopardize the ruling the Bank had obtained from the banking authorities.²⁶ In any event, the much emphasized Comptroller's examinations, whatever their scope, are policing and enforcement devices. They are not a substi-

²⁵ Compare the Public Utility Holding Company Act of 1935 where the Commission was given discretion in this area. See note 66, p. 31 of our main brief.

²⁶ So that there is no misunderstanding, contrary to the Commission (Br. p. 18), our position is that it did afford "undue latitude to the Bank contrary to the policies and purposes of the Act", and indeed sacrificed Section 10(c). The Commission's concern was not, as it should have been, with observance of the Section 10(c) policy, but with the need to abandon that policy because the banking authorities would only permit a bank's entry into the mutual fund business on terms that violate Section 10(c), which was the only reason given by the Bank in its application. See note 23 *supra*.

tute for a prophylactic rule. If examinations were an acceptable substitute, there would have been no need to enact Section 10(c), since the Investment Company Act also provides for comprehensive inspections.

Lastly, as it strains to find support, the Commission even attempts to justify its action in the name of free competition—the grant of “exemptions necessary to permit” the Account “to function in conformity both with the Act and with Federal banking laws furthers the basic policy of free competition” (Br. p. 20).²⁷ We fully appreciate the fact that an exemption was necessary to permit the Account to operate in conformity with the banking laws. And our position has been that this was the Commission’s overriding concern rather than the enforcement of the policy of Section 10(c), which should have been the Commission’s sole concern. In that provision the Congress concluded that the interests of investors would be best served if they were not offered participations in bank dominated investment companies. This competition the Congress concluded was deleterious.

2. The Committee

Our argument below, as summarized in our main brief (p. 33), was that investment company directors must have, but the Committee did not have, the ultimate responsibility for investment decision and management, the essence of an investment company’s being. We argued that the Committee would abdicate in this area, and that Bank’s board

²⁷ Grasping at straws, the Commission derives from the statutory provision that bars a miscreant from entering the investment company business “an underlying policy” that “investors should have a broad choice of investment media” (Br. p. 19). The investment company industry has never suffered from any paucity in this regard for, as Mr. Schenker pointed out, it is “an industry which has so many variants and so many different types of activities . . .” Senate Hearings, p. 197. The sole concern of the statute is that the industry be operated in the interest of investors. In any event, for the sake of accuracy, it should be noted that there are certain financial requirements for entry into the business. See Section 14(a) of the Act, 54 Stat. 811, U.S.C.A., Title 15, § 80a-14.

would assume this responsibility. In taking this position as to the duties of investment company directors we were only pursuing the Commission's view that "the exclusive right to supervise investment decisions . . . is the right and responsibility of the board of directors of a management investment company under the Investment Company Act."²⁸

It should be noted that we did not argue below, nor do we here, as might appear from the opposition briefs, that the Committee would not perform other functions of a board, so laboriously detailed in the briefs. This is all irrelevant for it would not cure the infirmity we had raised.

The Commission in its Findings and Opinion did not disagree with our view (or preferably its view) as to the above described duty of a board. Nor did it state that the matter we had raised was irrelevant. Its Findings and Opinion, if responsive to our argument, must be read to mean then that it assumed that the Committee would not abdicate its responsibility as we had maintained. The Commission in its brief (p. 27) urges that it was warranted in making an assumption in "the absence of *any* showing to the contrary" (emphasis added).

Suffice it to say that there was enough of a showing so that the dissenting Commissioner concluded that "The 'single entity' interpretation is a realistic appraisal of the true nature of the Bank's proposed operation" (JA 70). This by itself refutes the Commission's argument that there was an absence of any showing.

²⁸ Our main brief, p. 34, note 69 (In that note, the word "investment" after "management" was inadvertently omitted from the quotation referred to above). This same approach has been reflected in the Commission's statement that the "significance of the requirement of unaffiliated directors to provide a responsible and objective observation of and consideration of the activities of a fund's managers is seriously lessened if such directors do not play an active role in management . . ." Directors must be furnished with information about investments ". . . to enable them to participate effectively in the management of the investment company." *Imperial Financial Services, Inc.*, Securities Exchange Act Release No. 7684, p. 13 (August 26, 1965).

Next, having denied our motion to elicit the facts as to the much referred to, but never explained, "supervision" as it relates to the area we had challenged, the Commission now argues that we offered "no factual basis." This motion, as we explained in our main brief (p. 35, note 72), was prompted by the Bank's statement in its brief that the Comptroller's regulations provided for "exclusive management" by the sponsoring bank. This is in accord with Section 9.7(a)(1) of the Comptroller's regulations which imposes management responsibility on the bank. This is so whether or not a committee is used, and whether or not the Committee here is of the type referred to in the Comptroller's regulations, another belabored irrelevancy.

The Commission is silent on the matter of the "exclusive management" provision of the Comptroller's regulations. It speaks (Br. p. 29) of "supervision" being in the hands of the Committee, and calls attention to a letter of the Comptroller, which uses the same term but at the same time points out that "pursuant to a management agreement . . . the bank will be responsible for the management of the investments in the commingled account." (Br. p. 29, note 41).

The Bank claims (Br. p. 47) that the "exclusive management" provision is not applicable. But then it acknowledges it will have complete investment discretion over the Account's portfolio. (Br. pp. 44-45, 2 and 3). It would appear that the "supervision" of the Committee will not be related to supervision with respect to investment management and decision, but to other matters, including the Committee's power to terminate the management agreement. This, however, is not the management supervision with which an investment company board is charged, and the presence of which the Commission must have assumed, as we have already indicated.

In this connection, the Commission's misapprehension is indicated by its statement (Br. p. 28) that "the Bank

will make initial investment decisions subject to post-audit by the Committee (JA 32)". The "post-audit" concept describes a practice in the investment company industry under which an investment adviser makes individual portfolio selections, but the board of directors, consistent with its ultimate responsibility for investment management, oversees and supervises the investment activity. This is not the situation here. The Commission's record reference for the above quoted statement is to a provision in the management agreement which provides only that transactions shall be reported to the Committee. There is no provision for directorial "post-audit" such as previously pointed out the Commission insists upon in the case of an investment company.²⁹

We submit that the Commission without basis concluded that we had made no showing so that it was warranted in "assuming". If the Commission's decision is not reversed for its failure to heed the policy of Section 10(c) of the Act, the case should be remanded to the Commission for reconsideration, and appropriate findings, with respect to whether or not the Committee will have all the duties contemplated by the statute.

Respectfully submitted,

MARC A. WHITE

General Counsel

National Association of
Securities Dealers, Inc.

888 - 17th Street, N. W.
Washington, D. C. 20006

JOSEPH B. LEVIN

BROWN LUND & LEVIN

1625 Eye Street, N. W.
Washington, D. C. 20006

Attorneys for Petitioner

November 1966

²⁹ See p. 13, *supra* and note 28.